Lave and Crandall on EPA's New Clean Air Standards

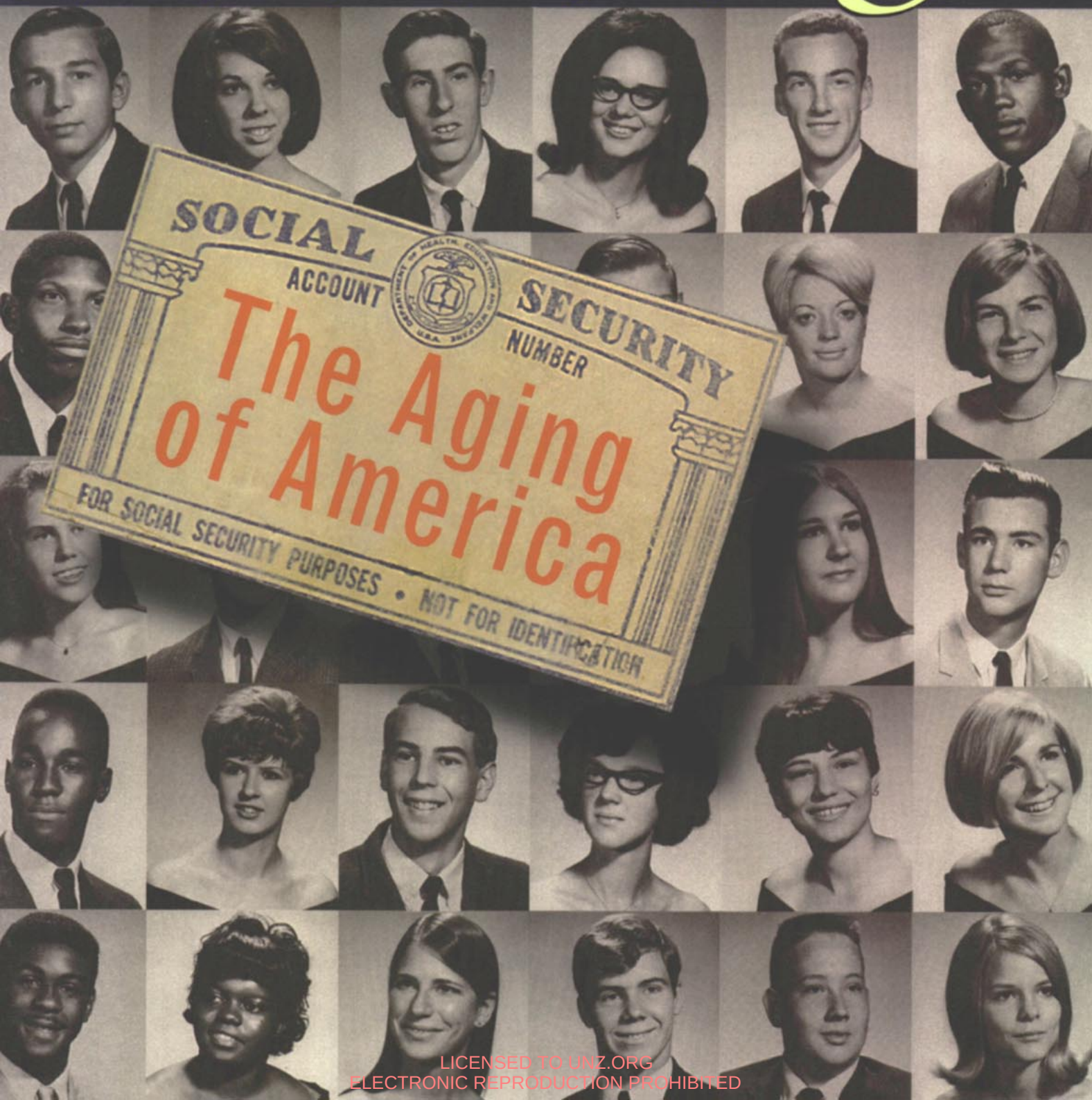
Noll and Zimbalist on the High Cost of Sports Stadiums

THE

Brookings

REVIEW

SUMMER 1997 $4.50 U.S./$5.50 CAN



LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

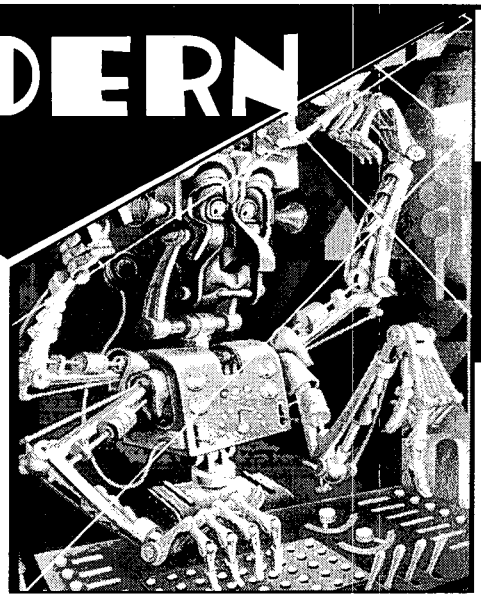
MODERN TIMES

Trapped in the Net

The Unanticipated Consequences of Computerization

Gene I. Rochlin

Drawing on fascinating examples from fields that range from military command, air traffic control, and international fund transfers to library cataloging and supermarket checkouts, Gene Rochlin shows that we are rapidly making irreversible and at times harmful changes in our business, social, and personal lives to comply with the formalities and restrictions of information systems.



"Rochlin has mastered an amazingly broad body of literature, grasped its deeper implications, and presented his results in a highly readable form, well peppered with anecdote and narrative."
—Paul N. Edwards, author of *The Closed World: Computers and the Politics of Discourse*

Cloth $29.95 ISBN 0-691-01080-3

Globalizing Capital

A History of the International Monetary System

Barry Eichengreen

It has become increasingly apparent that one cannot understand the international economy today without knowing how its monetary system operates. Barry Eichengreen has written a brief, lucid book that tells the story of the international financial system over the past 150 years. *Globalizing Capital* is intended for anyone with a broad interest in international economic and political relations.

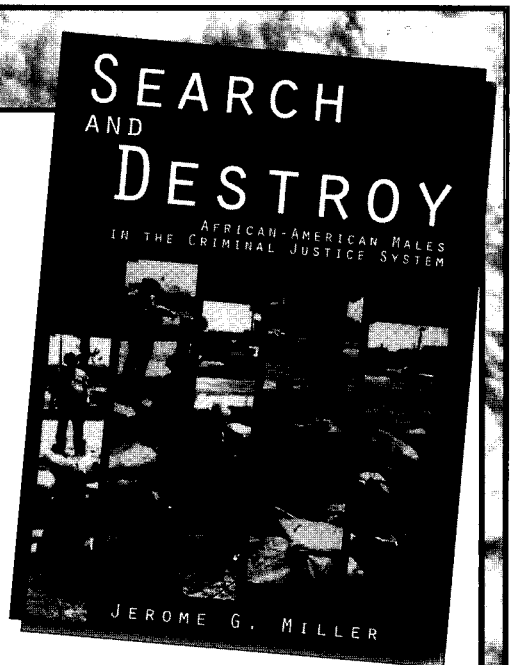
"Eichengreen's purpose is to provide a brief history of the international monetary system. In this, he succeeds magnificently. *Globalizing Capital* will become a classic."
—Douglas Irwin, author of *Against the Tide: An Intellectual History of Free Trade*

Cloth $24.95 ISBN 0-691-02880-X

Princeton University Press

AVAILABLE AT FINE BOOKSTORES OR DIRECTLY FROM THE PUBLISHER: 800-777-4726 • VISIT OUR WEBSITE: PUP.PRINCETON.EDU

NOW IN PAPERBACK...



Search and Destroy

African American Males in the Criminal Justice System

Jerome G. Miller

"Jerry Miller's Search and Destroy *is a riveting and important exploration into the criminal justice system in America today and its impact on young African American males. Everybody should read it and decide how to devote more energy to keeping our young men out of the criminal justice system. Something is wrong with the values of a nation that would rather spend far more to lock up children than spend far less to give them a Healthy Start, a Head Start, a Fair Start, a Safe Start, and a Moral Start in life."*

— Marian Wright Edelman, President, The Children's Defense Fund and author of *The Measure of Our Successes: A Letter to My Children and Yours*

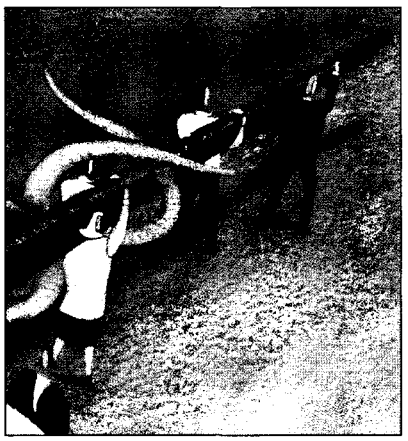
59858-3 Paperback $16.95

Available in bookstores or from CAMBRIDGE UNIVERSITY PRESS 40 West 20th Street, New York, NY 10011-4211 Call toll-free 800-872-7423. Web site: http://www.cup.org MasterCard/VISA accepted. Prices subject to change.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

THE Brookings REVIEW

SUMMER 1997 VOL. 15 NO. 3



JOHN BERRY

GLENN PIERCE

JOHN BERRY

FEATURES

4 **THE AGING OF AMERICA**
Will the baby boom be ready for retirement?
William G. Gale

10 **BUDGET CRUNCH**
Population aging in rich countries
Barry Bosworth and Gary Burtless

16 **PRIVATIZING SOCIAL SECURITY**
It's high time to privatize
Laurence J. Kotlikoff and Jeffrey Sachs

A bad idea whose time will never come
Henry J. Aaron

24 **MEDICARE: BEYOND 2002**
Preparing for the baby boomers
Robert D. Reischauer

28 **ETHNICITY**
An African predicament
Francis M. Deng

32 **A U.S.-JAPAN TRADE AGENDA**
Despite recent reverses, Japan is still a huge market that needs to be more open
Edward J. Lincoln

35 **SPORTS, JOBS, AND TAXES**
Are new stadiums worth the cost?
Roger G. Noll and Andrew Zimbalist

40 **EPA'S PROPOSED AIR QUALITY STANDARDS**
Clean air sense
Lester B. Lave

The costly pursuit of the impossible
Robert W. Crandall

DEPARTMENTS

2 **LETTERS**

3 **A CONSIDERED OPINION**
The Enemies of the Good
Martin Mayer

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

LETTERS

U.S.-Japan Strategic Relations

CONGRATULATIONS ON AN excellent spring issue. In particular, Mike Mochizuki ("Relations with the Great Powers: Japan") is dead right to call for a "new strategic bargain between Japan and the United States." But don't bet on any sudden deals. Having just restored Asian confidence in American staying power, the Clinton administration is unlikely to budge from its bumper sticker pledge to keep 100,000 troops in the Asia-Pacific region—or to clarify its fuzzy strategic goal of maintaining regional "stability." For its part, the government of Prime Minister Hashimoto would be all too happy to see Washington reduce U.S. troop levels on Okinawa. Just don't expect the eighth Japanese prime minister in ten years to reciprocate by mustering the political will to "say yes to collective defense and security missions." Mochizuki correctly notes that "the strategy of incrementalism . . . is seriously flawed." Barring a sudden outbreak of vision and leadership on either side of the Pacific, however, it will have to do for now.

James Gibney, Foreign Policy

No More Federal Aid for the District of Columbia

CAROL O'CLEIREACAIN'S ARTICLE on Washington, D.C. ("The Orphaned Capital: Revenue Options for the District of Columbia," spring issue), is not convincing.

First, let's make clear what O'Cleireacain is calling for. Behind all the smoke of reform, the central element in her plan is that more dollars from the nation's taxpayers should be given to Washington.

The question is why? The only justification for federal aid that O'Cleireacain offers is the exemption of federal property from local taxation. But, as she admits, the federal payment of $660 million a year already covers that—and more.

The second underlying theory for more federal dollars is that the District government is unfairly put upon because unlike other cities it has to provide "state-like" services. It doesn't have a state providing revenues and therefore the federal government should pony up. It is a weak theory.

Remember, states don't really provide the revenue—taxes from state taxpayers do. While there is no state in Washington, there certainly are all the taxes that every other state imposes. The District has a punishing income tax with a top rate of 9.5 percent (higher than most states) and hefty sales and excise taxes.

Well, perhaps the federal government should step in because the poverty in the District means it can't collect enough to fund state-like services. Oops, wrong again. Despite its economic problems, D.C. has a higher per capita income ($32,274 in 1995) than Virginia, Maryland, or any state in the nation. Thus, because of this wealth, even without huge new infusions of federal revenues, a reasonable tax system could fund needed services. And supposed structural problems notwithstanding, from 1980 to 1990 the city's annual revenues from federal and local sources managed to increase by $1.3 billion.

A commuter tax? After all, as O'Cleireacain argues, during workdays the labor force of the District doubles. But remember, those tens of thousands of people pay taxes—when they park, eat lunch, and shop. The public and private sector of the District already benefits greatly from their presence. A commuter tax would only drive more businesses out of the District—a real phenomenon that O'Cleireacain acknowledges.

O'Cleireacain makes the observation that "overspending is part of the problem." No, it is the whole problem.

From 1980 to 1990 Washington saw a 54 percent increase in operating costs (adjusting for inflation and population change). In Washington's schools, the city is spending $7,655 per pupil, which is 26 percent higher than the national average and $2,000 more than in comparable Baltimore. The city's Board of Education budget is almost five times that of Baltimore's.

The problem is not that the District government can't get enough of the citizenry's money, District apologists like O'Cleireacain notwithstanding. It is that city officials have deeply violated the public trust in deciding what to do with it.

John Berthoud, Alexis de Tocqueville Institution

School Choice: Evidence, Not Polemics

PETER W. COOKSON IS ONE OF the relatively few scholars in American education who has approached the controversial issue of school choice with the kind of balanced treatment that is needed to inform intelligent public policy. This is why his recent essay ("New Kid on the Block: A Closer Look at

continued on page 48

BROOKINGS PRESIDENT
Michael H. Armacost

VICE PRESIDENT, EXTERNAL AFFAIRS
John M. Hills

DIRECTOR, BROOKINGS PRESS
Robert L. Faherty

The Brookings Review

EDITOR
Brenda Szittya

PRODUCTION
Susan F. Woollen

PROOFREADER
Ellen Garshick

MARKETING
Jill Bernstein

ADVERTISING
Lalie Chambers
(202) 797-6106

CIRCULATION
Renuka Deonarain, Garry Sparks, Ann M. McDuffie

Design and art direction by Glenn Pierce/The Magazine Group

Copyright © 1997 by the Brookings Institution. All rights reserved.

Printed in U.S.A.

Subscriptions: one year $17.95 ($24.95 foreign); two years $32.95 ($46.95 foreign); three years $47.95 ($68.95 foreign). (800) 275-1447; (202) 797-6258

Postmaster, send address changes to:

The Brookings Review, 1775 Massachusetts Ave., N.W., Washington, D.C. 20036

Second-class postage paid at Washington, D.C. USPS I.D. No. 010-099; Publication No. 551640.

Reprint permissions: (202) 797-2483

U.S. newsstand distribution by: Ingram Periodicals Inc. 1117 Heil Quaker Blvd. La Vergne, Tenn. 37086 (800) 627-6247 (ext. 4500)

The Brookings Review (ISSN 0745-1253) is published quarterly by the Brookings Institution Press.

Visit Brookings online at: http://www.brook.edu

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

MARTIN MAYER

The Enemies of the Good

When the future graphs the history of public housing in the United States, two political events will appear as devastating declines.

The first was passage of the 1949 Wagner-Taft-Dingell bill that promised "a decent home . . . for every American family." From 1937 to 1949, public housing had helped provide affordable housing to low-paid workers. Washington subsidized the construction and pretty much removed the capital costs; the operating costs were to be paid by local authorities from the rent rolls. After 1949, public housing became increasingly a refuge for the jobless, a roster increasingly dominated by the socially disorganized, especially unwed mothers.

The second disaster was Senator Edward Brooke's 1975 amendment limiting the rent in public housing to no more than 30 percent of a tenant's income. A 1965 housing act had already freed local authorities from the requirement to pay operating expenses out of rent rolls, and Brooke assumed that an agency of government at some level would make up the difference between the cost of maintaining an apartment and the new rent ceiling. He did not contemplate what actually happened—that the local housing authorities would remain confined to their own income stream, and everyone who lived in "the projects" would suffer the effects of deterioration.

Meanwhile, advocates for the least successful students in the public schools pressed Congress to fund programs for "special education." Because the school systems received greater revenues if they had more problem kids, more kids were diagnosed with problems. When it was discovered that most of the children in the special ed classes did not improve their performance, the advocacy shifted to a philosophy of mainstreaming—there was still extra money for special ed, but children with problems were "entitled" to be with their peers. That entitlement, like all others, was enforceable in court.

Not infrequently, what made the children "special" was disruptive behavior. Teachers who can manage such behavior are hard to find. Run-of-the-mill teachers can be seriously distracted from their work with the rest of the class. Non-special children pay the price. In the end, just as the people who would make the best neighbors abandon the housing project, the teachers and children who set the tone of a successful school move away. The losers are the larger number who, of necessity, stay put.

These results derive from fundamental tendencies in the American polity. From the Enlightenment, Americans inherited a central belief in individual rights, whether or not they discomfit the majority. Americans have never had much sense of the greatest good for the greatest number.

Add a can-do philosophy and the idea that bad luck should be illegal, mix well in committee under the watchful eye of crusading lobbyists, and leave the definition of the legislative language to future court cases. Inevitably, you get "the essential fact" Senator Daniel Patrick Moynihan noted in *Maximum Feasible Misunderstanding*, his book about the "great national effort at social change" in the 1960s. His fact: "the government did not know what it was doing."

No small part of the problem is the reliance on lawsuits to enforce "rights." Judges must look backward to the law as it was on the date of the alleged transgression and remedy the individual damage. Lawsuits are anecdotes. Legislators are supposed to weigh future consequences to entire communities. To leave significant policies at the mercy of lawsuits is to invite the counterproductive "reform" that characterizes so much social policy, especially in the areas of public housing and public schools.

In both, we must manage what the police departments call "quality of life issues." Both do need money they're not going to get, but they need even more the power to determine what will most benefit the greatest number of their essentially voiceless populations. This will have some terrible consequences. Sadistic junior managers in brief authority will torment people required to keep their apartments in good shape or lose their housing. Hostile teachers will drive struggling students to tears and despair. Even the most robust administrative controls—and there is clear need for ombudsman procedures in both institutions—will not avoid awful anecdotes, some of which will make the newspapers.

But without such grants of authority our hopes will continue to be barriers to opportunities. A bill passed by Congress this spring on special education and several proposals on public housing begin to dismantle these barriers. We can get results through incremental progress—improving the skills of the more educable who don't now learn, cleaning out the squalor that now afflicts the more ambitious in public housing. Once we have learned to do the merely difficult, perhaps we can tackle the impossible. Today's governments cannot afford the wishfulness that lets the best become the enemy of the good. ■

Martin Mayer, guest scholar in the Brookings Economic Studies program, was a member of the President's Panel on Educational Research and Development in the Kennedy and Johnson administrations and the National Commission on Housing in the Reagan administration.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

WILL THE BABY BOOM BE READY FOR RETIREMENT?

BY WILLIAM G. GALE

The baby boom generation—the roughly 76 million people born between 1946 and 1964—has been reshaping American society for five decades. From jamming the nation's schools in the 1950s and 1960s, to crowding labor markets and housing markets in the 1970s and 1980s, to affecting consumption patterns almost continuously, boomers have altered economic patterns and institutions at each stage of their lives. Now that the leading edge of the generation has turned 50, the impending collision between the boomers and the nation's retirement system is naturally catching the eye of policymakers and the boomers themselves.

Retirement income security in the United States has traditionally been based on the so-called three-legged stool: Social Security, private pensions, and other personal saving. Since World War II the system has served the elderly well: the poverty rate among elderly households fell from 35 percent in 1959 to 11 percent in 1995.

But the future is uncertain. Partly because of the demographic bulge created by the baby boomers, Social Security faces a long-term imbalance. The solution, even if it involves privatization, must in some way cut benefits or raise taxes. The private pension system has changed dramatically in ways that give workers increased discretion over participation, contribution, and investment decisions and easier access to pension funds before retirement—thus raising questions about how well future pensions can help finance retirement. Personal saving, also problematic, has remained anemic for over a decade. Net personal saving other than pensions has virtually disappeared.

These developments would be enough to raise concern about retirement preparations under the best of circumstances. But the prospect of a huge generation edging unprepared toward retirement raises worrisome questions about the living standards of the baby boomers in retirement, the concomitant pressure on government policies, and the stability of the nation's retirement system.

Are the baby boomers making adequate preparations for retirement? In part, the answer depends on what is meant by "adequate." One definition is to have enough resources to maintain preretirement living standards in retirement. A rule of thumb often used by financial planners is that retirees should be able to meet this goal by replacing 60–80 percent of preretirement income. Retired households can maintain their preretirement standard of living with less income because they have more leisure time, fewer household members, and lower expenses. Taxes are lower because retirees escape payroll taxes and the income tax is progressive. And mortgages have, for the most part, been paid off. On the other hand, older households

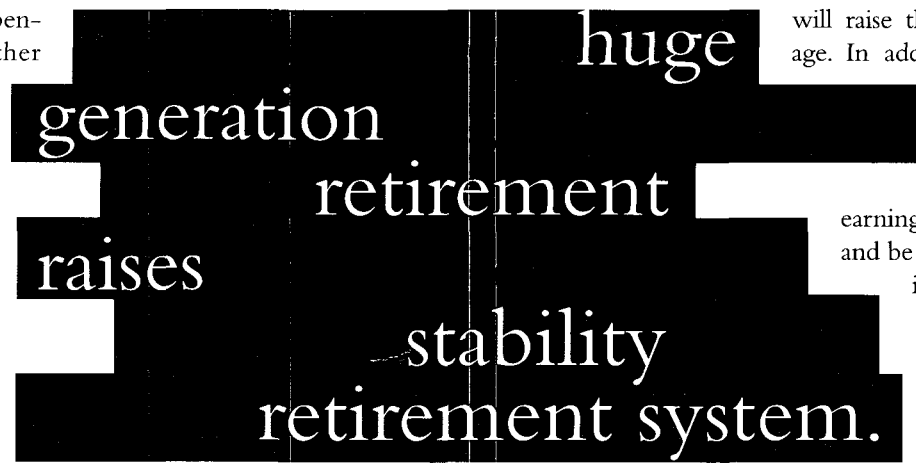
William G. Gale is Joseph A. Pechman fellow in the Brookings Economic Studies program. *This article is part of a broader study of saving funded by the National Institute on Aging and TIAA-CREF.*

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

may face higher and more uncertain medical expenses, even though they are covered by Medicare.

From a public policy perspective, assuring that retirees maintain 100 percent of preretirement living standards may be overly ambitious. But should policymakers aim to ensure that they maintain 90 percent of their living standards? Or that they stay out of poverty? Or use some other criterion? Retirement planning takes time, and these issues need to be addressed sooner rather than later.

A second big question is how to measure how well baby boomers are preparing for retirement. Studies that focus only on personal saving put aside for retirement yield bleak conclusions. One found that in 1991 the median household headed by a 65–69 year old had financial assets of only $14,000. But expanding the measure to include Social Security, pensions, housing, and other wealth boosts median wealth to about $270,000.



A third issue—crucial but as yet little explored—is *which* baby boomers are not providing adequately for retirement and how big the gap is between what they have and what they should have. Some boomers are doing extremely well, others quite poorly. Summary averages for an entire generation may not be useful as descriptions of the problem or as suggestions for policy.

The uncertain prospects for the baby boomers in retirement are particularly troubling because, as a society, we as yet understand little about the dynamics of retirement. Only one or two generations of Americans have had lengthy retirements, and the crucial retirement issues—health care, asset markets, Social Security, life span—keep changing rapidly, making long-term predictions even harder.

How Well Are the Boomers Doing? Interpreting the Evidence

Only a few studies have examined how well the boomers are preparing for retirement. The Congressional Budget Office recently compared households aged 25–44 in 1989 (roughly the boomer cohort) with households the same age in 1962. Boomer households, it turned out, had more real income and a higher ratio of wealth to income than the earlier generation. Though this finding seems promising, in fact the CBO study implies that baby boomers are going to do well in retirement only if (i) the current generation of elderly is thought to be doing well, (ii) the retirement needs of the two generations are the same, (iii) the experience from middle age to retirement is the same for both, and (iv) boomers will be content to do as well in retirement as today's retirees. None of these is certain. For example, although today's elderly are generally thought to be doing well, some 18 percent were living below 125 percent of the poverty line in 1995. And the boomers' longer life expectancy means that they will need greater wealth for retirement.

Whether the boomers and the previous generation will have similar experiences from middle age to retirement is an open—and still evolving—question. The earlier generation benefited from the growth of Social Security and housing values in the 1970s. But the boomers have gained from the dramatic rise in the stock market since the early 1980s, from smaller household size, which reduces living expenses, and from higher employment rates for women, which will raise their pension coverage. In addition, boomers are more likely to be in white-collar work and so should expect earnings to peak later in life and be able to work longer if they wish.

Finally, boomers may not be content with the living standard of today's retirees. They may aim instead for retirement living standards more comparable to those of their own working years. For all these reasons, how to inter-pret CBO's finding is unclear, even if the finding itself is unambiguous.

The most comprehensive study of these issues was undertaken by Stanford's Douglas Bernheim in conjunction with Merrill Lynch. Bernheim developed an elaborate computer model that simulates households' optimal saving and consumption choices over time, as a function of family size, earnings patterns, age, Social Security, pensions, and other factors. He then compared households' actual saving with what the simulations indicated they should be saving. His primary finding, summarized in a "baby boomer retirement index," is that boomers are saving only about a third of what they need to maintain preretirement living standards in retirement.

The index has attracted much attention but is not well understood. It does not measure the adequacy of saving by the ratio of total retirement resources (Social Security, pensions, and other assets) to total retirement needs (the wealth necessary on the eve of retirement to maintain preretirement living standards). Instead, it examines the ratio of "other assets" to the part of total needs not covered by Social Security and pensions.

As a result, the index reveals little about the overall adequacy of retirement preparations (see table 1). In case A, a hypothetical household needs to accumulate 100 units of

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

wealth. It is on course to generate 61 in Social Security, 30 in pensions, and 3 in other assets. Total retirement resources are projected to be 94 percent of what is needed to maintain living standards. But according to the boomer index, the household is saving only 33 percent of what it needs.

Thus, a baby boomer index standing at one-third does *not* imply that, absent changes in saving behavior, boomers' retirement living standards will be one-third their current living standard. It could mean that (as in case B), or it could mean retirement living standards will be 60 percent of current living standards (case C), or 94 percent (case A), or even over 99 percent (if Social Security and pensions were 99 and other saving were 0.33).

A second problem is that changes in the boomer index over time, or differences across groups, do not correspond to changes or differences in the adequacy of overall retirement saving. If, as in case D, the household in A rolls over its pension into an IRA, the boomer index soars, though total retirement resources are unchanged. If, as in case E, household A rolls over half of its pension into other assets and spends the rest on a vacation, the household has a higher boomer index, but less adequate total retirement preparation.

Finally, the boomer index can be extremely sensitive to estimates of retirement needs. In case F, retirement needs are 5 percent lower than in A, and the index rises from 33 percent to 75 percent. In case G, retirement needs are 7 percent lower than in A, and the index rises to 150 percent.

Bernheim points out that his model understates the retirement saving problem. The wealth measure, he notes, includes assets the household has earmarked for retirement as well as half of other (nonhousing) wealth. The model also assumes no cuts in future Social Security benefits, no increases in Social Security taxes, and no increase in life span.

But in other ways the model overstates the problem. It assumes that any man not covered by a pension at the time of the survey, when respondents are 35–45 years old, will never be covered, though pension coverage rates tend to rise a good bit as a worker ages. The model also likely understates pension benefits since it uses benefit data from the 1970s. Because the pension system grew rapidly from the 1940s to the 1970s, workers retiring in the 1970s likely had fewer years in the pension system and hence lower benefits than the boomers will upon retiring.

The model excludes all housing wealth and inheritances—no small matter, since, by Bernheim's calculation, including housing would raise the index to 70 percent, and a fair proportion of boomers is likely to receive substantial inheritances.

The model assumes that people will retire at age 65, though the normal Social Security retirement age will be 66 for most boomers, 67 for the youngest. The model also excludes all earnings after "retirement," though about 18 percent of the income of the elderly today is from working. And with partial retirement on the increase, retired boomers may work even more regardless of the adequacy of saving.

Finally, the model makes no allowance for retirees' lower work-related expenses or lower expenses for mortgages or other durable goods—such as furniture, appliances, and cars. Whether all these biases are larger or smaller than those in the opposite direction noted by Bernheim is unclear. Measuring and including these items is an important area for further research.

A New Perspective

Fundamental questions about retirement saving remain not only unanswered, but unasked. What proportion of households is saving adequately for retirement? What are the characteristics of those households? How has the proportion changed over time? Among those not saving enough, how big is the problem?

Table 2 begins to answer such questions by presenting my own estimates of the proportion of married households, with the husband working, who are "on track" toward accumulating enough wealth for retirement. The measure of "on track" is based on calculations in a study by Bernheim and John Karl Scholz, of the University of Wisconsin, that determines how much a household needs to have saved by a given age, given its earnings, prospective Social Security benefits, pension status, family size and other characteristics. (That study uses the Bernheim model described above, so the data suffer from all the biases already mentioned. Another bias here is that the sample includes only married couples where the husband works full time. Other married couples and singles are likely to be faring worse.)

When housing equity is not counted, slightly less than half of all households—and about the same share of all boomers—were saving

Table 1. Two Ways to Measure Adequacy of Retirement Saving

Units of wealth

Case	Social Security (1)	Pension (2)	Other assets (3)	Needs (4)	Total resources index (%) [(1)+(2)+(3)]÷4	Boomer index (%) (3)÷[(4)-(1)-(2)]
A	61	30	3	100	94	33
B	0	0	33	100	33	33
C	20	20	20	100	60	33
D	61	0	33	100	94	85
E	61	0	18	100	78	45
F	61	30	3	95	99	75
G	61	30	3	93	101	150

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

	Year	Proportion Saving Adequately When: Net assets exclude housing equity	Net assets include half of housing equity	Net assets include all of housing equity
All households[a]				
	1983	44	66	76
	1986	53	71	78
	1989	43	63	72
	1992	47	61	70
Baby boomer households[b]				
	1989	48	67	73
	1992	48	63	71

Source: Author's calculations from the Survey of Consumer Finances.

[a] Husband is aged 25–64 and works at least 20 hours per week.

[b] Husband was born between 1946 and 1964 and works at least 20 hours a week.

Thus, the glass can be viewed as half full or half empty. When housing equity is ignored, the typical household seems to be barely saving adequately or just missing. When housing is included, over two-thirds of households appear to have more than the minimum needed, given their age and other factors. Roughly speaking, a third of the sample is doing well by any measure, a third is doing poorly by any measure, and the middle third is (or may be) just hanging in there. Both of the following statements are equally true. Up to two-thirds of the households are now saving at least as much as they should be. And two-thirds are "at risk" in that any deterioration in their situation could make it impossible for them to maintain their living standards in retirement.

In short, two key factors matter tremendously to any characterization of the problem: the heterogeneity of saving behavior across households and uncertainty concerning the right measures of wealth to use.

adequately in 1992. When half (all) of housing equity is counted, the adequacy rate climbs to 61 percent (70 percent).

Adequacy rates rise with education and income. Within the baby boom generation, adequacy rates generally decline somewhat with age. They are higher for boomers with pensions than for those without, either because pensions raise households' overall wealth or because people more oriented toward saving and thinking about retirement are also more likely to have jobs with pensions.

High adequacy rates do not necessarily require high levels of saving. For example, suppose annual retirement needs are 75 percent of final earnings. According to the Social Security Administration, Social Security benefits replace about 46 percent of final earnings for the average worker earning $50,000 at retirement. (Note that in this example Social Security replaces 61 percent—46/75—of total retirement needs, as in case A in table 1. The percentage would be higher for workers with lower earnings.) With pensions typically replacing 25–30 percent of final earnings, a household with Social Security and a pension would not need much more saving to maintain adequate living standards, especially if the household can work for a time in retirement or expects to receive bequests.

As table 3 shows, the wealth shortfall among households that are not saving adequately (ignoring all housing equity) is relatively small for many. The median inadequate saver has a shortfall of $22,000, or about six months of earnings—a problem that could be solved either by postponing retirement for six months or by lowering retirement living standards a little. Even among 60–64 year olds, the median inadequate saver could completely resolve his or her saving shortfall by working for two more years past age 65.

Areas of Uncertainty

The boomers' prospects are also complicated by uncertainty in other areas: retirement patterns, life spans, home values, asset markets, health care costs, and the economy itself.

Average age at retirement, which fell through the 20th century for men, may start rising regardless of the adequacy of

Age	Shortfall: In dollars	Shortfall: In terms of annual earnings
25–29	2,960	0.12
30–34	3,400	0.10
35–39	13,180	0.37
40–44	26,940	0.73
45–49	33,500	0.82
50–54	65,100	1.25
55–59	51,800	1.47
60–64	75,470	2.17
All households	22,480	0.52
Baby boomer households	13,480	0.38

Source: Author's calculations based on the 1992 Survey of Consumer Finances.

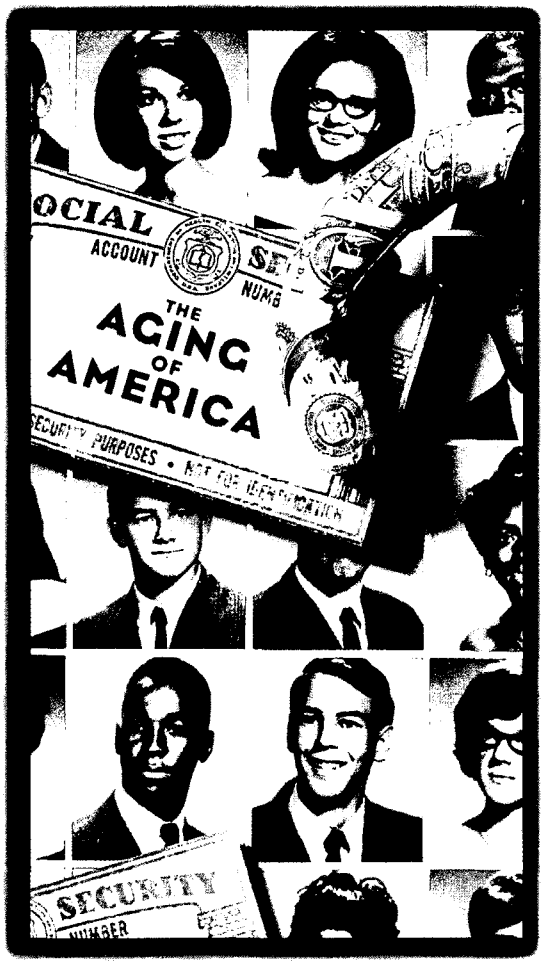
[a] The sample is households not saving adequately for retirement when housing equity is not included.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

saving. Many of today's jobs do not depend on "brawn" and can thus be done by older people. The normal Social Security retirement age will rise to 66 by 2009 and 67 by 2027 even if no further changes are made in Social Security.

Partial retirement may matter as well. Many retirees cut back on work gradually rather than abruptly. According to a study by economist Christopher Ruhm, only 36 percent of household heads retire immediately at the end of their career jobs. Nearly half remain in the labor force for at least five years. Of workers eligible for a pension, 47 percent continue to work after leaving their career job. If people continue to work even after retirement, they will be better able to support living standards in retirement.

A related uncertainty involves life span. Expected remaining life spans of 65 year-olds have grown in the past two decades and are projected to grow further. Living longer means having to stretch a given amount of money over a longer period.



Uncertainty regarding home equity is twofold. First, how will housing prices evolve? Both demographic pressures and the reduction in tax rates in the 1980s may reduce the long-term value of housing. And, second, regardless of housing values, to what extent should housing be counted as part of household wealth? In recent decades, the elderly have been reluctant to cash in their housing equity. But baby boomers have been willing to extract housing equity and were major recipients of home equity lending booms in the 1980s and 1990s. It remains to be seen whether the boomers in retirement will act more like themselves in earlier years or like current retirees. In any case, a household with low financial assets that lives in a $300,000 house and refuses to dip into housing equity may not be considered a pressing social concern.

Asset markets too are uncertain. Equity values cannot continue to grow as rapidly as they did in 1996. And even if the boomers accumulate what seem to be sufficient retirement funds, they will, loosely speaking, all want to cash in those funds at roughly the same time. That could mean massive sell-offs of stocks and bonds that could depress asset prices. Conceivably asset prices could fall sharply, but since markets are forward looking, asset prices may instead be stagnant for a long period. Finally, the evolution of health care costs and of the economy as a whole could have a major impact on the adequacy of retirement preparations.

> Roughly speaking, a third of the boomers are doing quite well, a third are doing poorly, and the middle is just hanging in there.

What's in Store?

The retirement prospects for the baby boomers are uncertain. One issue is what policymakers and boomers themselves will accept as a reasonable goal for retirement living. More thought needs to be given as to how to assess living standards when, as a matter of biology, retirees face declining health. In addition, they typically have more leisure time and can literally substitute time for money.

A second source of uncertainty is the boomers themselves. Whatever imponderables the economy as a whole may offer, baby boomers can improve their retirement prospects by saving more—that is, by reducing their current living standards.

What can government do? First, keep the fiscal house in order by reducing the long-term budget deficit in ways that do not reduce private saving. Second, the government could provide, or encourage others to provide, financial education to workers and households on how much they need to save. Third, the government should encourage people to use the many saving incentives already in place. Fourth, judicious Social Security and pension reform, especially pension reform that raises pension coverage, could help resolve these problems and raise private saving at the same time. ■

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

BUDGET

POPULATION AGING

BY BARRY BOSWORTH AND GARY BURTLESS

ILLUSTRATION BY GLENN PIERCE
PHOTOS COURTESY OF
H. ARMSTRONG ROBERTS

OVER THE NEXT SEVERAL decades the populations of the major industrial countries will grow considerably grayer. By 2030 the ratio of people past age 64 to those ages 15-64 will be just over 30 percent in the United States, close to 40 percent in France and Great Britain, and nearly 50 percent in Germany and Japan. The increased cost of retirement benefits will put enormous pressure on public sector budgets at a time when the workforce is scarcely growing or even shrinking. But though all the big industrial countries share the prospect of an aging population, no two face exactly the same future. Variations in the size and timing of the demographic changes, as well as important differences in public programs for the elderly, mean that population aging has different implications in each country.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

CRUNCH IN RICH COUNTRIES

Demography. Over the next several decades, the aged dependency rate—the ratio of people over age 64 to those of working age—will rise most steeply in Germany and Japan. Not only will the aged population increase, but the working-age population will fall (see figure). Indeed, the economic issues of population aging will be compounded by the possibility of actual population decline. Fertility rates in both Germany and Japan are far below the "replacement rate" needed to maintain a constant population, now about 2.1 children per woman. Official projections assume the fertility rate will gradually return to the replacement rate in Japan, but remain close to the current level (1.4) in Germany. German forecasts also assume substantial (but declining) immigration, an annual net flow of about 2 immigrants per 1,000 residents, compared with 5.6 earlier this decade. Immigration is assumed to be negligible for Japan.

France and the United Kingdom face less dramatic population change. Although fertility rates in both have declined (to 1.8), over the next quarter century the total populations of France and Britain are expected to grow, while the working-age populations remain roughly unchanged. Dependency rates will rise because of the growing number of the elderly.

Barry Bosworth and Gary Burtless are senior fellows in the Brookings Economic Studies program.

Though the aged population is projected to grow fastest in the United States, the U.S. aged dependency rate will grow the least. The U.S. fertility rate is now above 2.0, and immigration remains strong (4.4 per thousand residents), so the working-age population will continue to grow, although much more slowly than in the past.

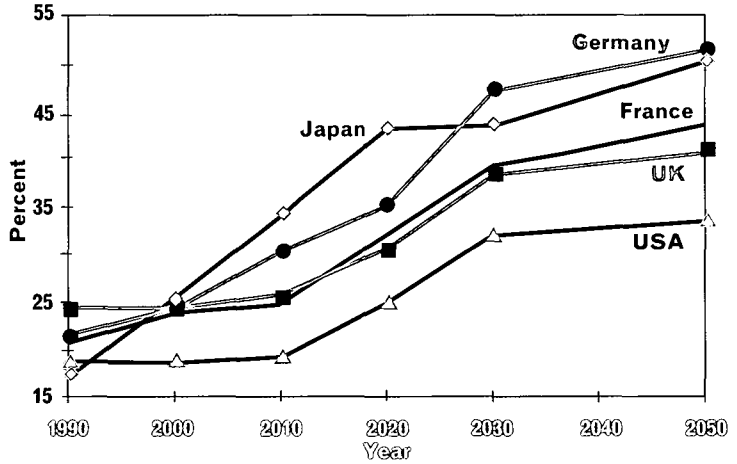
Official forecasts in all five countries suggest life expectancy improvements will slow. In Japan, for example, life expectancy is predicted to improve over the next 30 years at one-sixth the rate of the past 30. In the United States, it is predicted to rise at half the rate of the recent past. Germany projects no gains in life expectancy. Many demographers believe these projections understate likely improvements in longevity, implying an even greater rise in the aged dependency rate.

Pension Burdens. France, Germany, Japan, the United Kingdom, and the United States have all tried to improve the lot of their aged citizens over the past half century. By liberalizing public pensions and health insurance, all have sought to provide the elderly a living standard comparable to that enjoyed by the working-age population. By the mid-1980s, they had largely achieved their goal. Poverty had fallen sharply among the elderly, and living standards of typical aged and non-aged households had substantially converged.

The five countries differ widely in their spending on public pensions, however. Pension costs as a share of GDP are much higher in France and Germany than in Japan, Britain, or the United States (line 1, table 1). Not only do France and Germany provide more generous pension benefits (line 2), they also use public pensions to finance early retirement for the long-term unemployed, a practice that has depressed employment rates among people in their late 50s and early 60s.

Public pension costs are less burdensome in Japan, Britain, and the United States, in part because pensions are less generous, but also (in the case of Japan and the United States) because the populations are younger. The United States spends the smallest portion of GDP on public pensions. Its aged

Aged Dependency Ratios in Major Industrial Countries



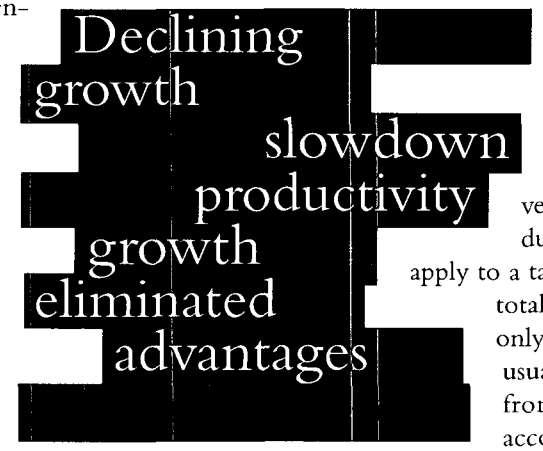
Source: National sources and World Bank projections.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

dependency ratio is the lowest, and its public pensions are, along with those in Britain, the least generous.

Each country's public pension system is distinctive (see box, pages 14-15). In France, Germany, and Japan, population aging and the generosity of the pension formula mean that public pension costs must rise rapidly. Reforms in the U.S. system in 1977 and 1983 will hold down spending increases. The normal retirement age, for example, will rise gradually starting early in the next century, reaching 66 for people born in 1943 and 67 for people born in 1960. That reform essentially reduces future pensions 12-14 percent. On the other hand, steep increases in the cost of Medicare will send U.S. spending on the elderly soaring in spite of only moderate growth in public pension costs. Britain took major steps during the 1980s to scale back public pension spending. The Conservative government cut future public pension commitments and offered financial incentives for workers to opt out of part of the public system.

The projected costs of public pension programs vary widely (line 3). France, Germany, and Japan are expected to encounter severe financing problems within the next few decades. In all three countries, estimated unfunded liabilities of the public systems exceed current GDP (line 4). The unfunded liability of the U.S. system is one quarter of GDP. Britain's net liability is near zero.



Reform. To restore long-term solvency to public pensions, policymakers confront a choice among four reform alternatives. Three—cutting benefits, increasing contribution rates, or raising the age of retirement—can be implemented within the present pay-as-you-go framework. The fourth moves away from pay-as-you-go toward advance funding of retirement obligations—either within the public system or in privately owned and managed pension funds.

Benefit cuts. Public systems are now the main source of income for most retirees, providing over 40 percent of total retirement income in the United States and up to 70 percent in Germany. Because many old people have fairly modest incomes (often just above the poverty line), most countries cannot reduce minimum pensions without increasing poverty. Many proposals for scaling back benefits therefore emphasize means-testing or modifying the inflation index.

Moving from an earnings-related to a flat-rate benefit could reduce public pension costs, but it introduces important incentive problems. Severing the link between a worker's earnings (and tax contributions) and his or her retirement pension discourages work and encourages tax evasion. It will be opposed by high-wage workers, who would pay a tax proportional to their earnings but receive only a minimum, flat-rate pension. To keep the contribution rate down in a reformed system, these workers would almost certainly press their political representatives to keep the basic pension low, putting many old people at greater risk of becoming poor.

Means-testing public pensions on the basis of retirees' current income can also lower costs. But it would discourage private pensions and saving, which might, perversely, make middle-income workers more reliant on public pensions.

Benefits can also be trimmed by reducing the inflation adjustment. To justify that step, some observers argue that nonmedical consumption needs decline with age. In the United States some also claim that the consumer price index overstates increases in the cost of living. But reducing the annual inflation adjustment would progressively reduce the real benefits of aging retirees as they grow older. Because most other retirement income is not indexed, this would exacerbate a pattern in which retirees' real income declines with age—and poverty rates rise.

Higher contributions. Raising contribution rates is a second option. But tax rates are already so high in many countries that raising them further would be very unpopular and, possibly, counterproductive. Often, though, the high tax rates apply to a tax base that is far less than 100 percent of total labor compensation. Wages are taxed only up to a certain limit. Fringe benefits are usually not taxed. (In fact, the gradual shift from taxable wages to untaxed benefits accounts for more than a third of the long-term U.S. retirement fund deficit.) Broadening the tax base could obviously close some of that gap. But some of the extra revenue would be offset by higher pension payments to workers credited with higher average wages. And many fringe benefits, such as health insurance, are hard to value, making it hard to calculate a worker's pension contributions.

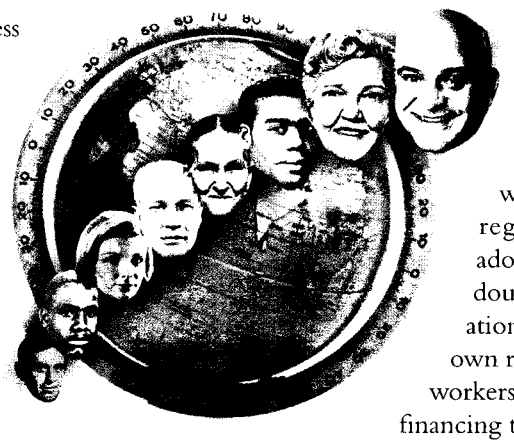
Raising immigration or the birth rate could also add contributors and revenue to the public system. But immigration is unpopular in Europe, in part because of high joblessness, and it has become much less popular in the United States in the past decade. Large-scale immigration has never been permitted in Japan. Germany now offers major incentives for childbearing, but it is hard to see any effect on the birth rate. And childbearing incentives may encourage women to stop working, partially offsetting the benefits of a higher birth rate.

Delaying retirement. Increasing the retirement age is another way to reduce pension costs. Although expected longevity at age 60 has increased about one-fifth since 1960, the earliest age for claiming pensions has been left unchanged or even reduced in the five big industrialized countries. Germany, Japan, and the United States plan to raise the age of entitlement for a full pension, but much less than the longevity increase over the past few decades. Because workers in most countries prefer to retire before the "normal" retirement age, raising the age of entitlement for full benefits without raising the early retirement age amounts to reducing benefits.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

Increasing the retirement age can certainly cut costs. The United States could erase its 75-year Social Security deficit by raising the retirement age to 67 today, increasing it gradually to 70 in 2030, and raising the early retirement age from 62 to 67. Delaying retirement is widely unpopular, however, especially among workers with physically demanding jobs. The evidence of the past few decades suggests, in fact, that most workers strongly prefer earlier retirement options.

Advance Funding. Proposals to address the financing problem through benefit cuts and tax increases are inherently divisive, because they force generations and income classes to vie over who will have to make the larger sacrifice.



It is possible to mitigate these divisions by increasing the national income that will finance the consumption needs of future workers and retirees alike. To achieve this, the current generation can increase its saving to finance more of its own retirement. Larger accumulations in retirement systems, whether public or private, over the coming decades would raise the nation's capital stock and raise national output. In the next century, the nation would be spending more on pension programs, but paying for it out of a larger economic pie, leaving a bigger slice of the pie for future workers.

The current pay-as-you-go system of financing public pensions does not increase national saving. In all the national systems under discussion here, payroll taxes from today's workers go almost entirely to pay for pensions for today's retirees. During the 1950s and 1960s, pay-as-you-go looked like a good idea. The labor force was growing briskly, and real wages were climbing 2-5 percent a year. The return on contributions once the system was mature was expected to be 4-7 percent a year, far more than ordinary workers could earn on their own savings.

Declining labor force growth and the dramatic slowdown in labor productivity growth have eliminated those advantages of a pay-as-you-go system. The rate of return has fallen below 2 percent a year in most countries and may soon become negative. Private investment alternatives offer workers and pension fund managers real returns exceeding 3 percent a year. In view of the difference in expected rates of return, many of today's workers and young voters would choose prefunded retirement accounts over pay-as-you-go.

Unfortunately, the pay-as-you-go system has inescapable consequences. Governments have accumulated huge pension liabilities to retirees and older workers. Democracies are unlikely to default on these obligations. Over the next several decades, current and future workers will pay for the promised pensions, regardless of whether governments adopt new advance-funded systems. The double burden of paying off those obligations and saving in advance for their own retirement makes it costly for younger workers to move cleanly from pay-as-you-go financing to advance funding.

Nonetheless, today's workers could increase the portion of retirement income they expect to derive from capital income and reduce the portion coming from payroll contributions of future workers. Governments could move toward partial funding of future retirement obligations either by modifying current public systems or by converting them fully or partially to private systems. In either case the central

Table 1. Public Spending on Pensions, 1995–2040

	France	Germany	Japan	United Kingdom	United States
1. Public pension costs–1995 (Percent of GDP)	10.6	11.1	8.6	6.5	5.1
2. Net replacement[a] (Percent)	78	63	55	50	50
3. Pension cost projections (Percent of GDP)					
2000	12	11	11	6	5
2010	13	12	14	6	5
2020	15	13	15	6	6
2030	17	14	16	6	7
2040	20	14	n.a.	6	7
4. Present value of net pension liabilities (Percent of GDP)	115	110	105	5	25

[a] After-tax value of public pension as a percent of after-tax wage while at work for average-wage worker.
n.a. Not available.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

question is whether the increment to funding would really add to national saving and capital formation and boost future national income or whether it would be offset by reduced public or private saving elsewhere.

Advanced funding is simplest to implement within existing public programs because it would leave accrued benefit claims intact. Increased contribution rates or reduced benefits (or both) would create a reserve, which should be strictly separated from other government accounts. The reserve would then be invested in either public or private securities. From the point of view of economywide gains, it matters little which. If the public pension fund purchased government debt, more private saving would go to finance private investment. If the public fund invested in private debt or equities, private savers would be forced to purchase more government debt.

Public management of a huge retirement fund, however, raises thorny political issues. Politics might skew investment decisions. Even worse, public officials might use reserve accumulations to offset deficits in other government accounts.

Private retirement accounts can reduce these political risks. In addition, they offer workers flexibility in managing their own retirement savings. Partial privatization, as in the two-tier system adopted by Chile in the early 1980s, is a possibility. A first-tier public program could provide a flat benefit or one related to the number of years of participation; the second-tier program could support a private defined-contribution pension program, with individual accounts invested in a range of capital market assets by the individual contributors.

But privatization too carries risks. Explicitly separating out the redistributional component could create strong pressure to reduce or eliminate it. A two-tier partially privatized system may not provide adequate income security for retirees with low lifetime earnings. Workers may make bad investment decisions. Converting individual accounts into annuities when workers retire or become disabled presents a huge challenge. Solving this and other problems entails high administrative costs that may eat into the returns of small accounts.

Individual retirement accounts have obvious appeal to high-wage workers, especially those with investment expertise. Setting up millions of IRAs—effectively, defined-contribution pension plans—eliminates concerns about the public costs of retirement programs. Benefits are determined by contributions and market interest rates, not by government contributions. But if millions of workers suffer losses on their investments, democratically elected governments may face enormous pressure to compensate them.

Five Public Pension Systems

FRANCE. The French pension system consists of several hundred pay-as-you-go plans. The biggest, the "régime général," offers an initial benefit of 50 percent of a worker's average wage over the 10 highest-earning years, but with earnings each year truncated at the social insurance ceiling. (For workers retiring in the next century, the average wage will reflect earnings in the 25 highest-earning years.) The pension, which is indexed to prices, is available to workers retiring at age 60 who have contributed to the system for at least 40 years. Workers who contribute for fewer years get a reduced pension. Most recipients of the basic pension also get benefits from supplementary schemes in which pensions are proportional to past contributions. This two-tier structure covers about two-thirds of the work force. Small regimes with specific rules also apply to various socioeconomic groups. Pensions are financed with payroll taxes on pensionable earnings plus a small proportional tax on total income.

GERMANY. In Germany's pay-as-you-go pension scheme, the basic benefit is based on the number of years of contribution and a worker's relative wage each year. A worker earning the average wage each year for 45 years of contribution receives a pension of 70 percent of the average net wage at retirement. Workers who steadily earn less than half the average wage receive a small extra benefit. Benefits are indexed to reflect annual changes in the economywide average net wage (the gross wage minus income taxes and social insurance contributions). The retirement age, 63 for men and 60 for women, will rise to 65 early in the next century. Early retirement pensions starting at age 60 are widely used as a substitute for unemployment compensation. Benefits are financed with some general revenues but mainly with a proportional wage tax on earnings up to a maximum taxable level.

JAPAN. The Japanese public pension has two components: a flat-rate basic benefit and an earnings-related pension. The first-tier benefit is available to all residents. In 1995 the maximum monthly benefit for a 65-year-old worker who had contributed for 40 years was 65,000 yen (about $360 in terms of equivalent purchasing power). The average benefit was 45,000 yen ($250), about 12 percent of the average wage. Benefits are adjusted over time in line with consumer price inflation. If real wages rise, the benefit falls relative to the economywide average wage. The first-tier benefit is financed by a flat tax (12,300 yen a month) on each insured person plus a general tax subsidy.

The second-tier, or earnings-related, pension is available only to employees. Firms that offer an equivalent private pension can opt out of this part of the public system. Benefits are paid beginning at age 60 at

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

The Key: Economic Growth. Public programs for the elderly already consume a large and growing portion of public expenditures. For France, Germany, Japan, and the United States, the percentage of public budgets targeted on the elderly will rise sharply in the coming decades unless current laws are changed.

Britain is the exception to this general pattern. Recent policies have curbed the future growth of public spending on first-tier public pensions and encouraged workers to opt out of the second-tier public fund. As a result, future U.K. retirement incomes will depend increasingly on returns earned in privately managed and invested pension funds.

If all goes as planned, Britain will accumulate substantial reserves in its (increasingly private) pension system. If the budget deficit is kept low, those growing accumulations can help boost national saving, which in turn can spur economic growth. But there is a risk. Workers who invest their retirement funds badly may have to retire on pensions substantially lower than their preretirement incomes. A lengthy period of low or negative private market returns may leave an entire cohort of workers facing the prospect of low retirement incomes. This shortfall may be more than a problem for the unfortunate workers. If voters demand good incomes for workers in retirement, it might also create huge problems for the public budget.

The United Kingdom, like other countries, must support its retired population out of the national income available to it. Whether retired workers get most of their income through public pensions, as in Germany, or private pensions, as in the U.K., their consumption will be derived from the output of future workers and the future capital stock. If future productivity grows rapidly, the elderly can be generously supported while workers enjoy steady increases in their after-tax incomes. If productivity grows slowly, future workers will have to accept lower after-tax incomes or retirees smaller pensions unless workers can be persuaded to delay their retirement. The implications of slow growth will be the same whether pension incomes come from public or private sources. One way to increase economic growth is to accumulate larger pension fund reserves to boost national saving. Whether the reserves are accumulated in a public or private fund, they can contribute to future national income only if they yield an increase in overall saving. ■

the rate of 0.75 percent of the average wage per year of contribution. A worker with 40 years of service would get a second-tier pension equal to 30 percent of the lifetime wage. In computing the initial benefit, past earnings are adjusted for wage inflation. Later benefits are adjusted to reflect price inflation. The second-tier program pays the first-tier pension for workers who retire before age 65. Thus, most workers can retire at 60 and get a full pension. Early in the next century, however, the first-tier pension will be limited to those 65 and over. The second-tier pension is financed by a premium proportionate to the after-tax wage.

UNITED KINGDOM. The UK has a two-tier pension system. The second-tier, earnings-related pension is small, however, and firms and workers can opt out of it into privately managed programs. The retirement age is 65 for men and is being increased from 60 for women. The basic benefit has fallen to about 18 percent of the average wage. The second-tier pension pays 1.25 percent of average real covered wages for each year of contribution up to 20. A worker with 20 years of contributions receives a combined pension that replaces about 43 percent of average earnings. Recent legislation will scale back the second-tier public pension by about 20 percent. Over time, benefits will fall even further relative to the average wage because the basic benefit and the upper limit for defining covered wages both rise in line with prices rather than average wages. More than two-thirds of employees have already opted out of the second-tier program. In effect, Britain is gradually reducing the scope of its public pension system, though retirees will receive increased pensions under private programs. As a result, Britain does not face the financing problem for public pensions that confronts other industrialized countries.

UNITED STATES. The United States operates a single unified plan for self-employed workers and all private-sector and most public-sector employees. Its system, a pay-as-you-go defined-benefit plan, covers about 97 percent of the workforce. The initial benefit is linked to a worker's average real wage in the 35 highest-paid working years. Past earnings are indexed to reflect wage inflation. Benefits are adjusted each year to reflect changes in the consumer price index. The benefit formula provides proportionately higher benefits for workers with low lifetime earnings. Benefits are financed with a proportional payroll tax on wages and net self-employment income up to a maximum annual amount ($65,400 in 1997).

An American worker who earns the economywide average wage each year will receive a retirement benefit at age 65 of about 43 percent of his or her real final wage. Because wages are more heavily taxed than public pension benefits, the net replacement rate is about 50 percent. Benefits for a dependent spouse equal half the breadwinner's pension. A typical benefit for a married couple with only one earner is 64 percent of the worker's pre-tax wage. The gross replacement rate is much lower when the married couple has two earners. The age of entitlement for a full pension is 65, though workers can claim a reduced pension as early as age 62. A 1983 reform will gradually raise the normal retirement age to 67. The early retirement age will not change.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

PRO

PRIVATIZING SOCIAL SECURITY

IT'S HIGH TIME TO PRIVATIZE

BY LAURENCE J. KOTLIKOFF AND JEFFREY SACHS

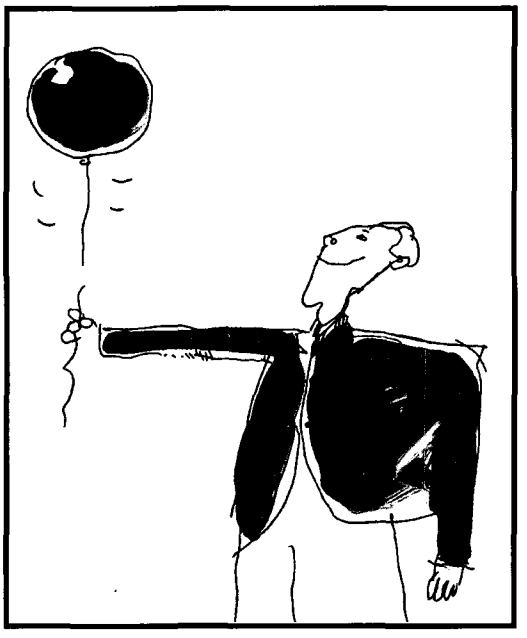


ILLUSTRATION BY BRU ASSOCIATES

Laurence J. Kotlikoff is professor of economics at Boston University. Jeffrey Sachs is professor of economics at Harvard University.

The Social Security system is in growing financial distress. It is unfair. It is inefficient. And it is user unfriendly. Tinkering with it at the edges will solve none of these problems. The solution is to privatize the retirement portion of the system—in a way that is fiscally sound, equitable, efficient, informative, and accessible.

The System Is in Crisis

The Social Security system faces a long-run funding crisis. Crisis is a strong word, one we don't use lightly. According to the conservative projection (known as the "high-cost" projection) of the system's actuaries, we need to raise, immediately and permanently, the combined employer-employee OASDI payroll tax rate by 50 percent—from 12.4 percent to 18.4 percent—to avoid having to raise the tax rate by a much larger percentage down the road.

This required 6 percentage point payroll tax hike is huge! We Americans have only 100 percentage points of our earnings to give away to assorted government bodies, and these bodies are already taking a hefty share of what we earn. Furthermore, Social Security is not our only insolvent entitlement program. According to the Health Care

continued on page 18

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

A Bad Idea Whose Time Will Never Come

BY HENRY J. AARON

Repeated often enough, even demonstrably false statements come to seem true. The assertion that Social Security faces enormous problems requiring large benefit cuts or tax increases is a case in point. Supposedly well-informed people have repeated this allegation so often that one risks losing credibility by challenging its accuracy. But it is false.

Sensible discussion follows from facts. The fact is that Social Security is adequately funded for 30 years and that its long-term financing problem can be solved by reforms that entail no serious modification of the basic structure of the program and no payroll tax increases.

ILLUSTRATION BY BRU ASSOCIATES

Henry J. Aaron is a senior fellow in the Brookings Economic Studies program.

How Big Is the Problem?

Between 1997 and 2035, the cost of Social Security is projected to rise 2 percent of gross domestic product. The increase, over nearly 40 years, is the same as that in the cost of Social Security from 1970 to 1982—just 12 years—and the drop in defense spending from 1989 to 1996—just 7 years. The point is not that any of these shifts is negligible. It is that the past changes in the costs of Social Security and national defense

continued on page 19

PRIVATIZING SOCIAL SECURITY

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

Financing Administration's conservative Medicare projections, we need to raise, immediately and permanently, the Hospital Insurance payroll tax rate by more than 10 percentage points. Adding this tax hike to the requisite 6 percentage point Social Security tax hike would more than double the FICA tax, leaving ourselves and our kids sending almost one in every three dollars we earn to these programs.

Now the self-styled defenders of Social Security will tell you that "Medicare is Medicare's problem" and that "Social Security's finances aren't all that bad." On Social Security they say, "Use the actuaries' intermediate projection, not their conservative one." According to the intermediate projection, only a "modest" and "manageable" 2.5 percentage point immediate and permanent payroll tax hike is needed. (This increase is for the entire future; for the next 75 years, the requisite tax hike is 2.2 percentage points.) Furthermore, they'll tell you that this "moderate" problem can be handled with a much smaller payroll tax hike if one also a) raises the retirement age for receipt of benefits, b) changes the formula that calculates benefits, c) taxes all of Social Security benefits under the federal income tax, and d) makes other minor modifications to the system. Their packages of proposed fixes are carefully tailored so that each fix, by itself, seems small. But together they add up to reducing our lifetime labor incomes and those of our children by roughly 2.5 percent.

Giving away another 2.5 percent of our labor incomes to Social Security, as the intermediate projection tells us we need to do, is a major, not a minor matter. But history teaches us, and prudence compels us, to judge Social Security's finances based not on the actuaries' intermediate projection, but on their conservative one. Anyone old enough to remember how Social Security was "saved" in 1977 and again in 1983 should understand that the intermediate projection is not to be trusted.

The fact is that the intermediate projection has routinely been overly optimistic—and by a wide margin. That, after all, is why Social Security's finances are, yet again, in crisis. The current intermediate projection, which in any case forecasts a 37 percent increase in Social Security costs relative to GDP, appears to be seriously off base on two counts. First, it assumes much smaller improvements in longevity than our top demographers forecast. Second, it assumes much higher future real wage growth than we've experienced in recent decades.

The System Is Unfair

It's well known that our pay-as-you-go Social Security system has effected an enormous redistribution from current and future Americans to cohorts who are now either elderly or deceased. What is less well known is that the system also redistributes large sums from men to women, from single people to married couples, and from two-earner couples and singles to single-earner couples.

Take, as an example, a 40-year-old single man earning $25,000 in 1997. For this man, the lifetime net tax from participating in Social Security measured as of age 65 is $397,000. (This and related numbers in this section were calculated by Eugene Steurle, of the Urban Institute, using a 6 percent real discount rate.) For him, participating in Social Security is equivalent to arriving at age 65 with $397,000 less in assets—a fantastic sum for someone earning only $25,000 a year. The corresponding loss for a single woman the same age and with the same earnings is $14,000 less—because, on average, women's greater life expectancy allows them to collect benefits longer than do men. Now if this single man and woman were to marry and only one of them were to work, their net loss from participating in Social Security would drop to just $134,000 per person, or roughly one-third their net loss when they are single. The reason for this difference in the treatment of one- and two-earner couples is that Social Security provides dependent and survivor benefits for free to noncontributing spouses.

> Social Security's enormous intergenerational redistribution is well known. Its intragenerational redistribution is also huge—and capricious.

Now suppose the nonworking spouse of the couple decides to work and earns $11,000 a year. The per person loss now becomes $241,000. The loss is large, but it's smaller than the $276,000 loss each would incur, on average, were they single. The $35,000 additional loss from being single again reflects the fact that Social Security provides dependent and survivor benefits to spouses free of charge.

Social Security's intragenerational redistribution is enormous and capricious. Would the American public freely choose to take tens of thousands of dollars from single people and give them to married people? Would the public freely choose to take hundreds of thousands of dollars from two-earner married couples and give them to single-earner married couples? Unlikely.

The System Is Inefficient

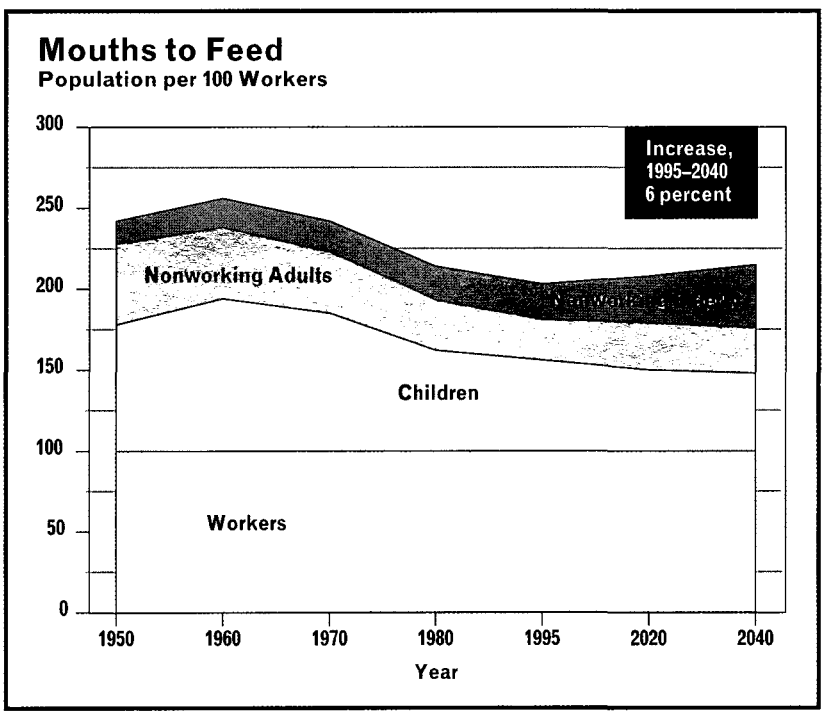
The benefit provisions of Social Security are so complex and arcane that most Americans have very little understanding of how the system redistributes among them. They also appear to have little understanding of what their marginal contributions will yield in terms of marginal benefits. The failure to link, closely and clearly, Social Security benefits to Social Security contributions means that most contributors are likely to view the system's 12.4 percentage point payroll tax as a pure tax. Given the size of other marginal labor income taxes and given the fact that the distortion of labor supply decisions rises as the square of the total effective tax on labor

continued on page 20

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

were as large as the projected change in Social Security costs and happened far faster, but without being seen as either a huge challenge or an enormous windfall. A little perspective is in order.

What about the projected decline in the ratio of workers to retirees—from roughly 3 to 1 in 1995 to roughly 2 to 1 by 2035? It looks as if each worker, who now takes care of one-third of a retiree, will have to take care of half a retiree in 2035—a 50 percent increase. But the real financial burden workers everywhere and at all times face is the need to support *everyone* who does not work, not just the elderly, as well as themselves. The total population per 100 workers (see figure), at a long-term high in 1960, has since fallen about 20 percent to a long-term low. The principal reasons have been a drop in the number of children per worker and, to a smaller degree, a rise in the proportion of women who work (hence, a drop in dependent non-aged adults). The number of elderly retirees per worker has risen, but not much. Over the next 45 years, it will rise rapidly. The number of dependent non-aged adults per worker is projected to stop falling, as a decrease in the share of men who work more than offsets some further increase in the share of women who work. Partially offsetting these trends, the number of children will keep dropping.



The total number of mouths each worker has to feed will rise about 6 percent over the next 45 years, not the 50 percent suggested by focusing only on retirees. Worker productivity growth of barely 0.1 percent a year would offset that burden. In 2040, the burden will be 16 percent lower than in 1960.

But the elderly are supported publicly, children and dependent non-aged adults, mostly privately. Doesn't the shift in who is dependent create serious stresses on public finances? Changing financial arrangements for a program as politically sensitive as Social Security is never easy. But the economic size of the problem is not large, and those who wish to see sober and sensible action must make this fact clear.

Solving the Problem in Six Steps

Even if costs are not rising as much as some have said, won't it take heroic changes in Social Security to close the deficit? You be the judge. The program outlined below would not only close the projected long-term deficit, but create a surplus.

Reform 1. Under current law, government employees in a few states and localities are not covered by Social Security. Most, however, earn eligibility for Social Security through employment before, during, or after their government work—and they get far more in Social Security benefits than Congress intended. Social Security benefits are calculated based on average earnings in the 35 years of highest earnings. These state and local workers, who have considerable earnings during their years outside Social Security, are recorded as having none. Because their average Social Security earnings appear low, they get the relatively higher benefits intended for low earners as well as their state or local pensions. Legislation enacted in 1977 reduced, but did not eliminate, the problem.

The recent Social Security Advisory Council voted unanimously to bring all new state and local hires under Social Security. This reform eliminates 10 percent of the projected deficit.

Reform 2. Increasing from 35 to 40 the number of years over which average Social Security earnings are computed would reduce benefits because the additional 5 years, by definition, would be lower than the highest 35. Most members of the Advisory Council embraced an increase to 38 years. Going to 40 years would close 21 percent of the deficit.

Reform 3. Contributory private pensions are subject to the personal income tax, unless the pension repays money that has already been taxed. In the case of Social Security, only the worker's payroll tax has been subject to personal income tax. Making all Social Security benefits taxable would bring the tax treatment of Social Security in line with that of private pensions. It would eliminate 13 percent of the deficit.

Reform 4. In 1983 Congress approved a phased increase in the normal retirement age from 65 to 67—two months a year from 2003 through 2008, and from 2020 to 2025. This measured pace gives the word "leisurely" a whole new meaning. Avoiding abrupt changes for vulnerable older workers is compassionate, but the 12-year hiatus is surely over-cautious. Eliminating it would close 5 percent of the deficit.

Reform 5. A quarter-century ago, conservatives, exasperated by liberals who regularly raised Social Security benefits in

continued on page 21

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

supply, the Social Security system could well be doubling the distortion of Americans' labor supply decisions.

Americans patient enough and smart enough to decipher the precise degree of benefit-tax linkage under Social Security will find quite different answers depending on their situations. If they are secondary earners, they'll find that their marginal contributions yield zero additional retirement and survivor benefits. If they are primary earners, they'll learn that each dollar they contribute may produce more than a dollar in additional benefits.

Would Americans vote for a system in which many secondary earners receive not a penny back in Social Security retirement and survivor benefits despite a lifetime of contributing to these programs? Would they vote to subsidize, at the margin, the labor supply of primary earners (primarily men) as part and parcel of overtaxing, at the margin, secondary earners (primarily women)?

The System Is User Unfriendly

Ask yourself the following question. When was the last time the Social Security system, on its own, sent you a benefit statement? The answer, of course, is never. Next, ask how long it takes the system to send you a benefit statement after you request it. The answer is about six weeks. Finally, ask yourself whether the statement you get tells you the amount of your retirement benefits in today's dollars or in future inflation-eroded dollars that you can't easily interpret in terms of current purchasing power. The answer is in future inflation-eroded dollars.

Ask yourself the following question. When was the last time the Social Security system, on its own, sent you a benefit statement? The answer, of course, is never.

Now we are all free to plow through Social Security's 500-page handbook to try to figure out our own benefits, but the handbook is so poorly written and so confusing that even Social Security's actuaries say it's hopeless.

Certainly, Social Security could improve its benefit reporting. But since the system hasn't, in over half a century, been able to figure out how to send out regular benefit statements, don't hold your breath. Moreover, Social Security's benefit statements are not only economically illegible, they also come with a false advertisement. Specifically, they contain assurances from the Social Security Commissioner to the effect that workers can rely on receiving their specified benefits when they reach retirement. As indicated above, Social Security's long-term finances are so dire that workers can, in truth, rely on precisely the opposite of the Commissioner's assurance.

The Personal Security System

The Social Security system is in deep water. Fortunately, there's a solution that makes sense, that's fair, and that is consistent with all the legitimate goals of the old system. The solution is to privatize the retirement portion of Social Security. Our privatization proposal, which we call the Personal Security System (PSS), has been endorsed by 70 of the country's top academic economists, including three Nobel prize winners. The proposal has the following seven features:

- *Social Security's Old Age Insurance (OAI) payroll tax is eliminated and replaced with equivalent contributions to PSS accounts.*
- *Workers' PSS contributions are shared 50–50 with their spouses.*
- *The government matches PSS contributions on a progressive basis.*
- *PSS balances are invested in a regulated, supervised, and diversified manner.*
- *At age 65, PSS balances are annuitized on a cohort-specific and inflation-protected basis.*
- *Current retirees and current workers receive their full accrued Social Security retirement benefits.*
- *A value-added tax or a federal retail sales tax finances Social Security retirement benefits during the transition, as well as the PSS contribution match.*

- *Scope of the proposal*: Only the OAI payroll tax (about 70 percent of total OASDI contributions) is eliminated. Contributions made to and benefits received from the Disability Insurance and Survivors Insurance portions of the Social Security system are unchanged.

- *Earnings Sharing*: To protect nonworking and secondary-earner spouses, total PSS contributions made by married couples are split 50–50 between the husband and wife before being deposited in each's own PSS account.

- *Government Matching of PSS Contributions*: The federal government matches PSS contributions of low-income contributors on a progressive basis. It also makes PSS contributions through age 65 on behalf of disabled workers.

- *Tax Treatment and Survivor Provisions of PSS Accounts*: PSS contributions are subject to the same tax treatment as current 401k accounts. Contributions are deductible and withdrawals are taxable. Through age 65, survivor provisions governing PSS balances are identical to those governing 401k accounts.

- *Investment of PSS Account Balances*: Workers and their spouses invest their PSS contributions in regulated, supervised, and diversified investments. For example, these investments might be restricted to inflation-indexed, exchange-rate hedged, high-grade domestic and international government and corporate zero-coupon bonds that come due when the worker reaches age 65. Alternatively, the portfolio rules could specify particular equity and debt shares that might vary by age, but that preclude trying to "time the market." Investment transactions costs need not be large. Workers would be in certified and highly diversified index funds that, like such funds now on the market, would be forced by

continued on page 22

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

election years to offset inflation and then took political credit for it, persuaded Congress to make the inflation adjustment automatic. The reform assured the retired and disabled that their benefits would retain constant purchasing power. The principle has never been challenged, but many analysts believe that the price index used to adjust benefits greatly overstates inflation. If analyses by the Bureau of Labor Statistics reveal that the index should be lowered by 0.5 percentage point, less than half the change recommended recently by a commission chaired by former chairman of the Council of Economic Advisers, Michael Boskin, that change would cut the deficit by 32 percent.

Reform 6. It seems only fair that Social Security reserves be managed so that beneficiaries have the same investment opportunities as private savers do. It also seems fair that Social Security beneficiaries receive returns on their payroll taxes that reflect the benefits to society resulting from Social Security reserve accumulation.

Let's be clear on one fact. Each extra dollar of saving earns the same return whether it is saved privately or through Social Security. Private saving makes that dollar available directly for private investment. The social gain is the private rate of return. Adding a dollar to Social Security reserves reduces federal borrowing from the public by a dollar, leaving an extra dollar of private saving for private investment. The social gain from adding to Social Security reserves is, again, the private rate of return.

Unlike private pension funds, Social Security reserves cannot be invested in private securities. The prohibition means that Social Security will pay smaller benefits than private pensions can pay for each dollar of tax or contribution although the social returns to both forms of saving are identical. The differential guarantees invidious comparisons with returns on private savings and thereby jeopardizes long-term public support of social insurance. Lifting the prohibition would close 37 percent of the deficit.

Some observers fear that lifting this prohibition would expose Social Security trustees to pressure to make politically motivated investments. But managers of the Federal Employees Retirement System and of the pension funds for the Federal Reserve System and the Tennessee Valley Authority, all of which invest in private securities, have remained entirely independent in their fund management. As an added safeguard, Congress could create an organization, modeled on the Board of Governors of the Federal Reserve System, to manage the Social Security trust fund and its investments. Members would be confirmed by Congress, appointed for lengthy, staggered terms, and removable only for criminal behavior. The record of the Board of Governors makes quite clear that such appointees are able to carry out their responsibilities without suffering political manipulation.

To be sure, Congress could direct such an organization to pursue politically motivated policies, just as it could force the Board of Governors to skew monetary policy for political reasons. It could also force private managers of federally approved private plans to follow mandated investment rules. But protection against such interference is political, not legal. Experience in other countries shows that governments can interfere with those who manage monetary policy and who supervise investment of public and private pension funds. But in the United States independent administrative frameworks have been sustained before and can be sustained in the future as long as the American people insist on it.

Even without investing Social Security reserves in private securities, the first five changes close more than four-fifths of the long-term deficit and would keep the Social Security trust fund solvent until well past mid-century. The six steps I have outlined may not be the best ways to restore long-term balance in Social Security, but they surely show that restoring the system to balance over the next 75 years requires no fundamental change in benefits and no increase in payroll taxes.

> Restoring the system to balance over the next 75 years requires no fundamental change in benefits and no increase in payroll taxes.

Privatization Plans

While the air of crisis around Social Security is bogus, it is surely legitimate to ask whether the welfare of the nation could be improved if all or part of Social Security were replaced with individual savings accounts. It is hard to address this question generally because the various "privatization" proposals differ so much. But all, including that by Laurence Kotlikoff and Jeffrey Sachs, raise two key issues. The first is who bears the risk?

All savings plans carry risk. It may prove impossible to sustain deposits at planned levels. Investment returns may fall short of expectations. Who should bear these risks? All privatization plans put the risk on the individual. Each worker bears the full consequence of shortfalls in deposits or returns on his or her individual account, and the pension is reduced proportionately. This is an inescapable characteristic of "defined-contribution" plans in which the contribution rate is specified, but the amount contributed depends on earnings and the ultimate benefit depends on investment returns.

In contrast, social insurance is a "defined-benefit" plan that diffuses risks broadly among all workers and across generations. The benefit formula is fixed, and workers and their employers through payroll taxes or the government through other taxes must meet those commitments. The risk workers face is political: that elected officials will change benefits or taxes.

Herbert Stein illustrates the choice by asking which of the following two options is preferable for a basic retirement plan—

continued on page 23

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

competition to levy extremely low fees. If the government chose, for example, to restrict PSS account balances to being held in a market-weighted global financial securities index fund, that fund's fees would be priced at only 20 to 30 basis points. Furthermore, such a restriction would eliminate workers' abilities to time the market. Since all fund managers would have to offer the same portfolio, moving from one fund manager to another would not alter one's portfolio.

• *Annuitization of PSS Account Balances:* PSS balances cannot be withdrawn before age 65. At age 65, PSS balances are pooled with those of other cohort members. The federal government purchases, in a competitive fee-bidding process, single-life, real annuities for each cohort member in proportion to his or her PSS account balance.

• *Payment of Social Security Retirement Benefits to Current Retirees and Workers:* Current recipients of Social Security retirement benefits continue to receive full inflation-indexed benefits. When current workers retire, they receive the full Social Security retirement benefits accrued as of the time of the reform. These benefits are calculated by filling in zeros in the OAI earnings records of all Social Security participants for years after the transition begins. Since new workers joining the workforce will have only zeros entered in their OAI earnings histories, new workers will receive no OAI benefits in retirement. Thus, over a transition period aggregate Social Security retirement benefits will decline to zero.

• *Financing the Transition:* During the transition, Social Security retirement benefits will be financed by a value-added tax or a federal retail sales tax (to be collected by the states). The PSS tax will also finance the government's PSS contribution match. Over time, the PSS tax rate will decline as the amount of Social Security retirement benefits declines. Provisional calculations suggest that the VAT or sales tax would begin below 10 percent and would decline to a permanent level of roughly 2 percent within 40 years.

PSS Advantages

Simulations of this approach to Social Security reform show long-run improvements in U.S. living standards of more than 10 percent and long-run increases in the U.S. capital stock of roughly one-third. These gains reflect the partial alleviation of the enormous fiscal burden facing future generations arising from current entitlement programs.

How will the PSS affect the poor? Social Security's cost-of-living adjustment insulates its beneficiaries from the potential increase in consumer prices associated with the new PSS tax. Hence, the current poor elderly will experience no higher fiscal burden. Moreover, simulation analyses show that poor members of the current middle-aged generation, of the current young generation, and of future generations have the most to gain from privatizing Social Security.

The PSS proposal asks current Americans, old and young, to help pay off Social Security's unfunded retirement benefit liability. Since it insulates the current poor elderly, only rich and middle-class elderly face a higher fiscal burden. Asking them to pay their share of Social Security's unfunded liability is intergenerationally equitable particularly given the massive and growing Medicare burden facing future generations.

Unlike many Social Security reform proposals, the Personal Security System would substantially alleviate the fiscal crisis facing future generations. It would also improve economic efficiency by linking retirement income to retirement saving without sacrificing secondary earners and the poor.

The Personal Security System would improve benefit-tax linkage, enhance survivor protection, equalize treatment of one- and two-earner couples, offset the ongoing transfer of resources from the young to the old, provide better divorce protection to nonworking spouses, make the system's progressivity apparent, resolve Social Security's long-term funding problem, and ensure Americans an adequate level of retirement income. It would also, over time, provide a considerable boost to the economy. What more could one want? ■

RESPONSE TO THE AARON PLAN

Henry Aaron's plan to close the Social Security financing gap is based on the intermediate, not the conservative, projection and thus provides well below half the cost saving we believe is needed. It involves dragging all new state and local government workers into Social Security. It also involves chopping current workers' benefits by altering the benefit formula in ways they won't understand, taxing more of their benefits under the federal income tax, and advancing the already legislated rise in the Social Security retirement age. Aaron thus gives workers a large dose of bad medicine in separate droppers. He gets another third of his cost saving from lowering the over-indexation of Social Security benefits, something we also support.

Aaron's residual "cost saving" comes from investing the Social Security trust fund in the stock market. This is a mistake. To see why, note that we, the public, now hold stocks and private and government debt securities outside the Social Security trust fund and that we hold government debt securities within the trust fund. Aaron proposes for the trust fund to sell us its debt securities in exchange for some of our stocks. Since it's our trust fund, this simply reshuffles accounts—we move some of our stocks into the trust fund and move the debt securities in the trust fund into our private accounts. Since stocks earn, on average, a higher return than do debt instruments, we end up, on average, earning more income in the trust fund and less outside it, though the same total income. But since the Social Security actuaries don't properly adjust for risk in their calculations (indeed, they make no risk adjustments), Social Security's finances will be misprojected to look better when they haven't changed at all. To see this, note that were this asset swap to take place today, the market value of the trust fund assets wouldn't change, nor would the system's projected future benefit payments or tax receipts. So a proper present valuation of the system's finances would show no change. That Aaron would calculate a 37 percent improvement in the system's long-term financing gap (under intermediate assumptions) is testimony to the depth of his accounting error.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

one that guarantees a retirement income equal to 50 percent of average earnings or one that gives a 50–50 chance of 120 percent of average earnings or nothing? The latter has a higher expected value, 60 percent of income on average. But for the basic retirement program, the sure bet of social insurance is preferable. One should not subject the mass of the public, most with few assets and therefore little capacity to withstand financial reverses, to the uncertainties inherent in individual investment accounts.

Actually, Stein's example unduly favors plan two, at least as embodied in most privatization proposals. If both plans invest in the same assets, the returns potentially available under social insurance are higher, not lower, than under private plans. If, under the private plans, each person is free to choose among funds, and the incomes of fund managers hinge on that choice, selling and administrative costs will be high. Under the much-vaunted Chilean privatized pension system, such costs have averaged 20 percent of fund incomes, about the same as for U.S. life insurance companies. Based on Chilean experience, and adjusted for population, sales staffs would total some 450,000 in the United States.

The plan proposed by Kotlikoff and Sachs is not as bad as other privatization plans in saddling workers with risks. It reduces the loss workers would suffer from a drop in wages by stipulating that the government should match workers' contributions "on a progressive basis." But they do not explain exactly what this means. They would also restrict the frequency with which workers could move their accounts. But no privatization plan can escape the central reality: if workers can shift accounts, private managers will spend money to induce them to do so. And no matter how much managers spend, workers as a group cannot earn more than the economywide average return on investments, less selling and administrative costs. They can earn the same return without the extra costs through social insurance.

I Asked for Ice, But This Is Ridiculous

This remark, attributed to a man standing at the bar in the Titanic, might stand for the reactions of many to the tax increase that Kotlikoff and Sachs propose. A 10 percent sales tax would generate between $300 billion and $500 billion in 1997, depending on whether all consumption was taxed or major exemptions, such as for education and hospital care, were allowed. Now that is a tax increase! This tax would come on top of the contributions workers would have to make to their personal security accounts. Kotlikoff and Sachs are quite vague on just what the various magnitudes would be.

Their reticence is understandable, because they face a problem that advocates of all privatization plans have to solve but few like to highlight. Social insurance operates on the principle that today's workers pay for today's retirees. In return, today's workers expect their retirement to be paid for by tomorrow's workers. Recently the United States edged away from this principle by requiring today's workers to pay more than is necessary to support the retired—roughly $60 billion a year more now, growing to more than $100 billion a year over the next decade. The intent was to ease the burden on tomorrow's workers and make today's bumper crop of workers pay in part for their own retirement.

Under privatization, today's workers would pay for all of their own retirement, as well as the full cost of pensions for today's retirees. That is why a big tax increase is necessary. In the Kotlikoff-Sachs plan, the payroll tax would be replaced by payments workers would make into personal accounts. The effect of the contribution on a worker's current disposable income, however, is the same as the payroll tax. The 10 percent sales tax would be an added burden. Without it, the Kotlikoff-Sachs plan collapses.

The real function of any tax is to discourage consumption, thereby boosting national saving. Many people now agree that the United States saves too little. In confronting proposals to boost saving, one has to ask two questions. How much? Is this the best way?

U.S. families now save 4–5 percent of disposable income and consume the rest, most of which would be subject to the 10 percent sales tax. If all consumption were covered, the sales tax would triple the proportion of their disposable income not available for consumption. If half of consumption were exempt, the proportion would double.

Forced saving of this size is unlikely to be acceptable in any form. But if the nation is to save so much, one is entitled to ask who is to consume less. In this case, it is the poor and middle classes, who consume most of their income. High-income families might not have to cut consumption at all. They could reduce voluntary saving to offset the new mandate. Most middle- and lower-income families do not currently save enough voluntarily to do so. Surely it is worth asking whether those who must consume all their modest income should be forced to contribute a larger proportion of that income to boosting national saving than those whose income now permits them to save a good share of it.

America's Best Antipoverty Program

Social Security faces a modest long-term deficit that Congress should address immediately. The system can and should be fixed, not scrapped. It is possible to do so without raising taxes or materially changing the program. Social Security has served the nation well and promises to continue doing so. It provides more than 80 percent of income to the lowest-income 40 percent of the elderly and disabled. For all but those in the highest-income 20 percent, it provides more than half of income. It is far and away the most important U.S. antipoverty program. It lifts 6 percent of the population out of poverty, double that of all other cash and in-kind assistance combined. Privatization is a bad idea because it places risks on individual workers that they should not be expected to shoulder and that Social Security now spreads broadly among all workers. It would create costly and needless administrative burdens. One can understand why large financial enterprises are spending millions to fund studies of privatization. They would gain enormously, but the rest of us would lose. ■

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

MEDICARE

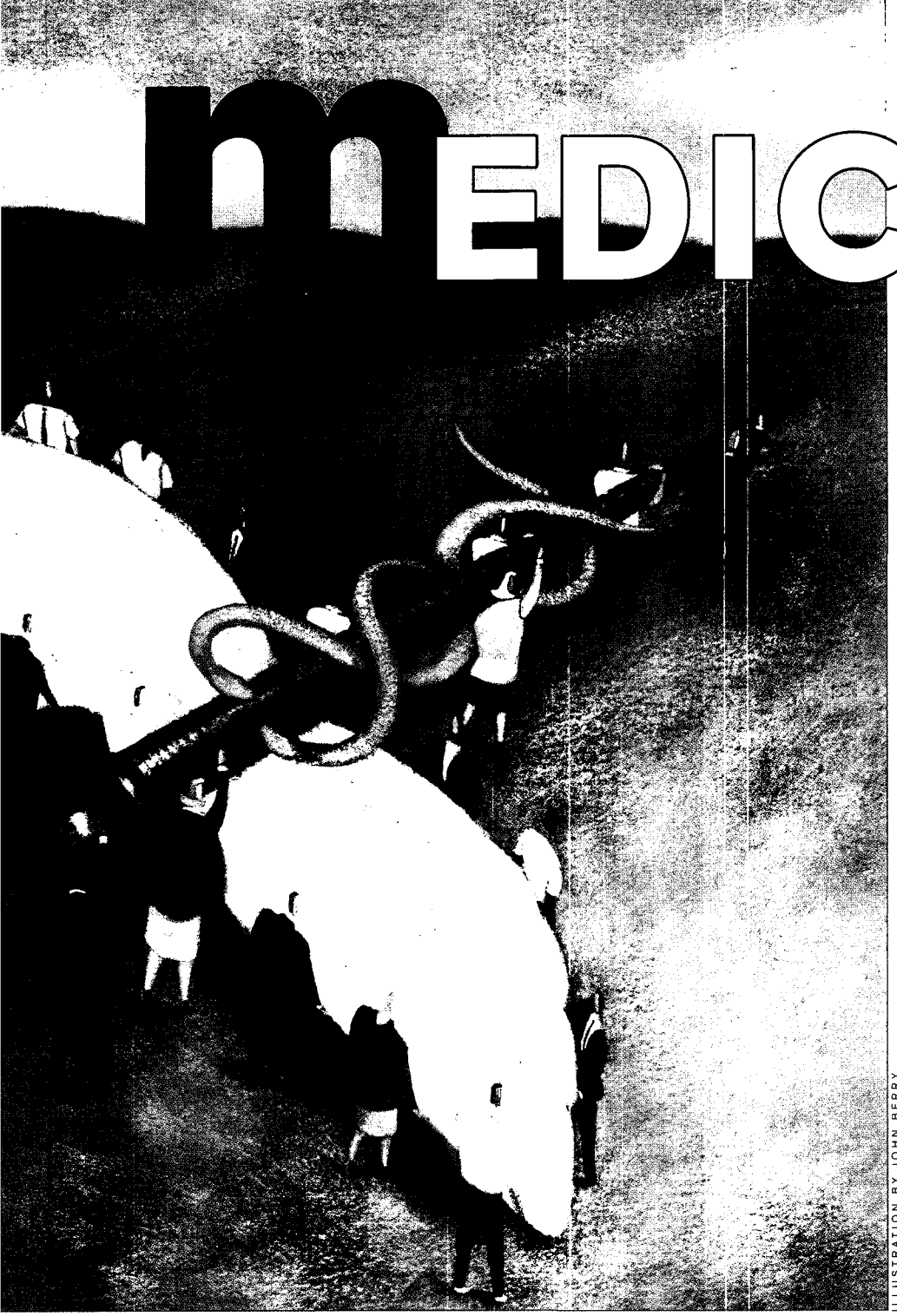


ILLUSTRATION BY JOHN BERRY

If Medicare is to provide the baby boom generation the same valuable protection against the ever-escalating costs of health care that it offers current beneficiaries, it must be reformed. The Clinton administration and many in Congress recognize this reality but seem content with modest changes implemented at a gradual pace. The reluctance of policymakers to act more boldly is understandable given the program's popularity among beneficiaries, the political clout of its providers, and its unquestioned societal benefits, which no one wants to jeopardize. But if over the next few years lawmakers do no more than enact incremental changes of the sort proposed by the Clinton administration and many in Congress, they will miss a unique window of opportunity. Medicare will continue to be a chronic policy problem and excessive resources will continue to be devoted to achieving its worthwhile objectives. From the perspectives of participants, providers, taxpayers, and government administrators, Medicare could be a stronger program in the next century if more fundamental structural changes were enacted now and implemented over the 13 years that remain before the first baby boomers begin to draw their benefits.

The Case for Fundamental Restructuring

Medicare needs serious restructuring for three reasons. The first is fiscal. Medicare spending will grow much faster than the economy over the next decade. Both the Clinton administration and the Congressional Budget Office project that Medicare costs will grow at close to a 9 percent annual rate if the program is left unchanged, while the economy will expand just under 5 percent a year. A program as big as Medicare—the third largest in the federal budget—cannot grow almost twice as fast as the economy for long without necessitating drastic cuts in other government activities, big tax increases, or larger budget deficits—none of which appears politically feasible or desirable.

A second reason for fundamental change is the need to bring the structures of Medicare and non-Medicare health insurance more in line. Employer-sponsored plans, Medicaid, and individual insurance are rapidly evolving into capitated systems using

Robert D. Reischauer, former director of the Congressional Budget Office, is a senior fellow in the Brookings Economic Studies program.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

Beyond 2002

PREPARING FOR THE BABY BOOMERS

BY ROBERT D. REISCHAUER

WHAT IS MEDICARE?

Medicare, the nation's health insurance program for the elderly and disabled, has two components. Hospital Insurance covers inpatient hospital, skilled nursing, home health, and hospice services. It is financed from a trust fund whose income derives largely from payroll taxes paid by all workers and their employers. Supplementary Medical Insurance, or Part B, covers outpatient hospital, physician, laboratory, and other services. Roughly three-quarters of its costs are borne by general revenues, with the balance coming from premiums paid by participants. About one-eighth of Medicare participants choose to obtain their health care services through approved HMOs rather than through the traditional fee-for-service system.

panels of providers and some management of care. Medicare remains largely an unmanaged indemnity insurance program paying discounted prices to virtually any licensed provider who chooses to participate. The two systems require different institutional infrastructures to support them, and as they continue to diverge, unnecessary complexity and inefficiencies will develop.

Medicare's glaring inadequacies represent a third, and probably the most compelling, reason for fundamental reform. The standard benefit package offered through employer-sponsored insurance, other public programs, and even many individual policies is far more generous than that of fee-for-service Medicare. Medicare does not cover most outpatient prescription drugs, has no catastrophic protection, and covers few preventive services. As a result, about 70 percent of participants supplement Medicare with employer-sponsored retiree wraparound policies or individual Medigap insurance. To protect low-income Medicare participants without such policies from large out-of-pocket costs, the government has created a Medicaid safety net. But the safety net is inefficient, inequitable, and inadequate. It saddles states with a cost that should be borne in Washington and does little for many whose incomes are above its eligibility thresholds but too modest to bear, without severe strain, the costs of the services that Medicare covers only partially or not at all.

The problems faced by low- and moderate-income participants are likely to get worse unless Medicare is reformed fundamentally. Employers will continue to pare back or drop their supplementary policies for retired workers. Medigap premiums will grow rapidly as Medicare HMOs draw healthier-than-average participants out of the Medigap insurance pool. Pressure will mount to extend the safety net to more low- and moderate-income participants, thus making the system of protection for the elderly and disabled even more complex and inefficient. And until Medicare is restructured, its inadequate benefit package will be hard to improve.

What Are the Options?

Academics, policy analysts, and policymakers have proposed numerous approaches for restructuring Medicare that they believe can both enhance the protection it provides and save public resources. All would impose a tighter budget constraint on Medicare spending. They differ, however, as to how strong that constraint would be and how it would be enforced.

One approach would privatize Medicare by requiring workers to contribute a fraction of their earnings to special tax-advantaged accounts that they would use to buy health insurance when they retire. The retiree insurance market would be regulated to assure that policies were available, affordable, and renewable. Advocates argue that contributions to the special accounts could be lower than the payroll tax needed to support the existing Medicare program—or that the benefits could be more generous—because the money in the accounts would earn a high return. They also believe that people would purchase insurance prudently, buying neither too much nor too little, because they would be spending their own money.

A privatized system, however, would pose real risk for those with low earnings or long life spans whose accounts could not buy adequate insurance. Conceivably, an entire age cohort could find itself at risk if, shortly before it retired, expensive new med-

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

ical technologies were developed, inflation jumped unexpectedly, or the value of the financial assets held by the accounts dropped sharply. If Medicare were privatized, it would cease to be a federal budget problem, but public spending on health-related safety net programs would probably have to be expanded.

A second possibility would be to convert Medicare into catastrophic insurance. The deductible could be set high—say, $2,500 a year. The benefit package could be expanded to include services, such as outpatient drugs, that could count toward the deductible. Advocates argue that this approach would hold down costs because people would try to economize on medical spending below the deductible. Above that amount, where much of health spending takes place, risk would be borne by the catastrophic plan, and neither participants nor providers would have any incentive to economize. Many participants would want to buy supplementary policies to cover the catastrophic plan's deductible as well as certain uncovered services. If supplementary policies were permitted, they would emasculate the demand-reducing impact of the high deductible just as Medigap-type policies now undermine the restraining effect of Medicare cost-sharing. Without supplementary insurance, more of the costs of medical care would be borne by the sick and less by the healthy.

A third option is to transform Medicare into a defined-contribution program and give each participant a fixed amount with which to buy coverage from an approved plan operating in a regulated market. These payments, which could be given to the participant as a voucher or paid directly to the plan he or she chooses, would be risk-adjusted and might vary to reflect geographic cost differences as well. There would be no mandated benefit package, and plans whose costs exceeded the federal payment level would be free to charge supplementary premiums. If the plan's costs were less than the federal payment, the participant would receive a full or partial rebate. An accurate mechanism to risk-adjust Medicare's payments to plans, which does not now exist, would be crucial because without a common benefit package disproportionate numbers of relatively healthy participants may choose plans with limited benefits and, therefore, low premiums.

Under a defined-contribution system, the government would have an enforceable budget constraint because it would set the payment levels. Advocates believe that costs would be held down by competition between plans and by participants' strong incentive to join plans that provide quality services at reasonable prices. If health care costs grew faster than Medicare's payments per beneficiary, participants would ultimately be hit by a diminished quality of care, reduced services, or increased supplementary premiums.

Premium support, a fourth approach, resembles the defined-contribution option except that all plans would have to provide the same core benefit package, which would be more comprehensive than that now provided by Medicare. A common benefit package would make it easier for participants to compare plans and for the government to risk-adjust its payments to the plans. Medicare could set payments to the plans through competitive bidding, an option unavailable in the defined-contribution system, which has no common product. The payment in each market area could be set at the median bid. As long as the premium support amount was at least as large as the median bid, low-income participants would have a reasonable choice of plans. At first, only plans willing to accept the premium support amount as full payment could participate. Over time, this rule could be relaxed and plans with higher bids could be allowed to charge supplemental premiums for the basic benefit package, unless the practice badly divided participants by income or health status.

Under both the defined-contribution and premium support systems, a range of plan types—HMOs, preferred provider organizations, provider-sponsored organizations, and fee-for-service insurance—would be available, and the traditional fee-for-service Medicare option would be phased out.

Although no one in the Medicare debate has suggested such an approach, Medicare could also be nationalized—transformed into a National Health Service for the elderly and disabled. Medicare could contract with a limited number of private providers for needed services or employ its own providers, as the Veterans Administration does. Such a system could offer more complete coverage than Medicare does now. The budget constraint could be as strong as it is with the Veterans Administration system.

The alternative to fundamental restructuring is incremental reform. It would hold down federal costs by raising Part B premiums, restraining the growth of payments to providers, and increasing costs to participants through higher deductibles and increased coinsurance rates. Those latter costs, however, would be picked up by supplemental insurance, whose premiums would go up, thus raising costs to participants indirectly. A more straightforward and efficient approach would be simply to raise Medicare premiums. Incremental proposals would also reduce payments to Medicare HMOs—now set at 95 percent of the cost of fee-for-service Medicare. Incremental reform would leave unchanged the basic structure of the existing system—as well as all its problems. Some of the system's perceived advantages, such as the freedom to select one's own providers and to access any available procedure, may erode as payments to hospitals and physicians are continually ratcheted down.

Choosing among the Options

Political feasibility pretty clearly rules out the extremes—both pure privatization and nationalization. Catastrophic coverage would also be a tough sell because the vast majority of elderly seem to prefer health insurance that covers the cost of even routine, budgetable care. The incremental approach undoubtedly is the most politically feasible option now. But as time passes, workers and their dependents, whose taxes pay for most of Medicare's costs, may begin to wonder why Medicare participants continue to have expensive unrestrained access to providers and services when their own employer-sponsored coverage restricts their choice of providers and their access to certain expensive procedures. If a premium support system made

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

Medicare more like employer-sponsored insurance with respect to both limits and benefit adequacy, political support for it might grow.

Of all the alternatives, the premium support approach probably holds the most promise for restraining costs because it would both encourage competition among plans and use the most decentralized mechanism—competitive bidding by plans—to set the government's contributions to the plans. Both the premium support and defined-contribution approaches would be better than the incremental approach at weeding out unscrupulous providers and providing care most efficiently because, in both, the tough decisions would be made by health plans responding to market forces rather than government administrators whose flexibility would be curbed by political considerations.

A system of premium supports also holds the most promise for improving Medicare's benefit package. The package established through the political process would no doubt be similar to those of employer-sponsored plans. Because the defined-contribution approach has no set benefit package, its average benefit package could gradually deteriorate as plans competed with one another for participants. Cost considerations would continue to make benefit expansion problematic under the incremental approach.

70% of participants supplement Medicare with employer-sponsored retiree policies or Medigap insurance.

When Should Structural Reform Begin?

The sooner the nation begins restructuring Medicare, the more options policymakers will have and the less wrenching the changes will be. Conditions for restructuring are favorable on a number of fronts.

The economy is strong and can accommodate relatively painlessly the unavoidable dislocations arising from a major program restructuring. Demographic conditions are also favorable. The next decade will see a lull before the demographic storm breaks as the first of the baby boom generation turns 65 in 2011. The population aged 65 and over is projected to grow only 0.9 percent a year during the next decade—less than it did during the previous decade and much less than it will in the decade after 2007. This will give any new institutional structures created as part of Medicare reform time to become established before the boomers begin to turn 65.

Health market conditions too are conducive for Medicare restructuring. Providers, particularly hospitals and physicians, are in excess supply. As employer-sponsored plans have constrained their payments to providers, Medicare payments have become relatively generous. Medicare hospital margins—estimated at 12.7 percent for 1997—are higher than they have been in over a decade. Introducing structural reforms while market conditions are good will be unlikely, even with the inevitable slips and stumbles, to restrict access or compromise the quality of care received by Medicare participants.

Even political conditions are relatively favorable. The president is a lame duck. While he may be concerned about what Medicare reform may do to the fortunes of his party, he does not have to worry about his own reelection. In 2001, a new president will be facing reelection in 2004, when about 45 percent of the voters will be 50 and older. With Congress controlled by the Republicans and the White House in Democratic hands, any reform legislation enacted now will bear the fingerprints of both political parties. That won't make reaching an agreement any easier, but it does reduce the chances of demagoguery on the issue in the next election or of policy reversal if one party should control both Congress and the White House.

If restructuring were to start in 1997, how fast should it proceed? Prudence is a virtue in dealing with a program as vital to millions of vulnerable people as Medicare, but the pace preferred by the Clinton administration risks paralysis. The Health Care Financing Administration (HCFA) wants to demonstrate, test, and evaluate reform alternatives. But the answers to many of the important questions that HCFA is examining will never be clear from experiments and demonstrations that are not systemwide. Opponents of change will use the ambiguity of the results to forestall reforms. Current Medicare providers and participants will have reason to dig in their heels because one of the chief forces driving restructuring is the need to reduce the spending from which both benefit.

When the Republican majority in the 104th Congress passed the Balanced Budget Act of 1995, it showed a willingness to move rapidly on fundamental Medicare restructuring. It erred, however, in rigidly specifying the details of the future program and implementing them over a short seven-year period. No one yet knows just how far restructuring might go in the employer-sponsored health insurance market. It is precipitous to lock in place now a new structure for Medicare for the next century. Restructuring must be an evolutionary, not a revolutionary process.

But if the nation wants to restructure Medicare in ways that can benefit both participants and taxpayers, the process must begin soon and must proceed at a deliberate pace. Medicare restructuring will be complicated, divisive, and time consuming. New institutional infrastructures will have to be built, tested, and revised. Plans, providers, and participants will have to get used to the new structures and incentives. As the process unfolds, some mid-course corrections and adjustments will no doubt be necessary. But such uncertainties should not be used as an excuse for inaction. If meaningful Medicare reforms are not started before this century comes to a close, the window of opportunity may slam shut and the nation may be faced with few alternatives other than to raise taxes to support increasingly inadequate Medicare benefits. ■

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

Ethnicity

An African Predicament

BY FRANCIS M. DENG

History has stripped Africa's people of the dignity of building their nations on their own indigenous values, institutions, and heritage. The modern African state is the product of Europe, not Africa. To attempt at this late date to return to ancestral identities and resources as bases for building the modern African nation would risk the collapse of many countries. At the same time, to disregard ethnic realities would be to build on loose sand, also a high-risk exercise. Is it possible to consolidate the framework of the modern African state while giving recognition and maximum utility to the component elements of ethnicities, cultures, and aspirations for self-determination?

The Challenge of Ethnicity in Africa

Ethnicity is more than skin color or physical characteristics, more than language, song, and dance. It is the embodiment of values, institutions, and patterns of behavior, a composite whole representing a people's historical experience, aspirations, and world view. Deprive a people of their ethnicity, their culture, and you deprive them of their sense of direction or purpose.

Traditionally, African societies and even states functioned through an elaborate system based on the family, the lineage, the clan, the tribe, and ultimately a confederation of groups with ethnic, cultural, and linguistic characteristics in common. These were the units of social, economic, and political organizations and inter-communal relations.

In the process of colonial state-formation, groups were divided or brought together with little or no regard to their common characteristics or distinctive attributes. They were placed in new administrative frameworks, governed by new values, new institutions, and new operational principles and techniques. The autonomous local outlook of the old order was replaced by the control mechanisms of the state, in which the ultimate authority was an outsider, a foreigner. This mechanism functioned through the centralization of power, which ultimately rested on police and military force, the tools of authoritarian rule. This crude force was, however, softened by making use of traditional leaders as extended arms of state control over the tribes or the local communities, giving this externally imposed system a semblance of legitimacy for the masses. Adding to this appearance of legitimacy was the introduction of a welfare system by which the state provided meager social services and limited development opportunities to privileged sectors. National resources were otherwise extracted and exported as raw materials to feed the metropolitan industries of the colonial masters.

This new system undermined the people's indigenous system, which provided them with the means for pursuing their modest but sustainable life objectives, and replaced it with centrally controlled resources that were in short supply and subject to severely competitive demands. Development was conceived as a means of receiving basic services from the state, rather than as a process of growth and collective accumulation of wealth that could in turn be invested in further growth. The localized, broad-based, low-risk, self-sustaining subsistence activities gave way to high-risk, stratifying competition for state power and scarce resources, a zero-sum conflict of identities based on tribalism or ethnicity. Independence removed the common enemy, the colonial oppressor, but actually sharpened the conflict over centralized power and control over national resources.

Today, virtually every African conflict has some ethno-regional dimension to it. Even those conflicts that may appear to be free of ethnic concerns involve factions and alliances built around ethnic loyalties. Analysts have tended to have one of two views of the role of ethnicity in these conflicts. Some see ethnicity as a source of conflict; others see it as a tool used by political entrepreneurs to promote their ambitions. In reality, it is both. Ethnicity, especially when combined with terri-

Francis M. Deng is a senior fellow in the Brookings Foreign Policy Studies program.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

torial identity, is a reality that exists independently of political maneuvers. To argue that ethnic groups are unwitting tools of political manipulation is to underestimate a fundamental social reality. On the other hand, ethnicity is clearly a resource for political manipulation and entrepreneurship.

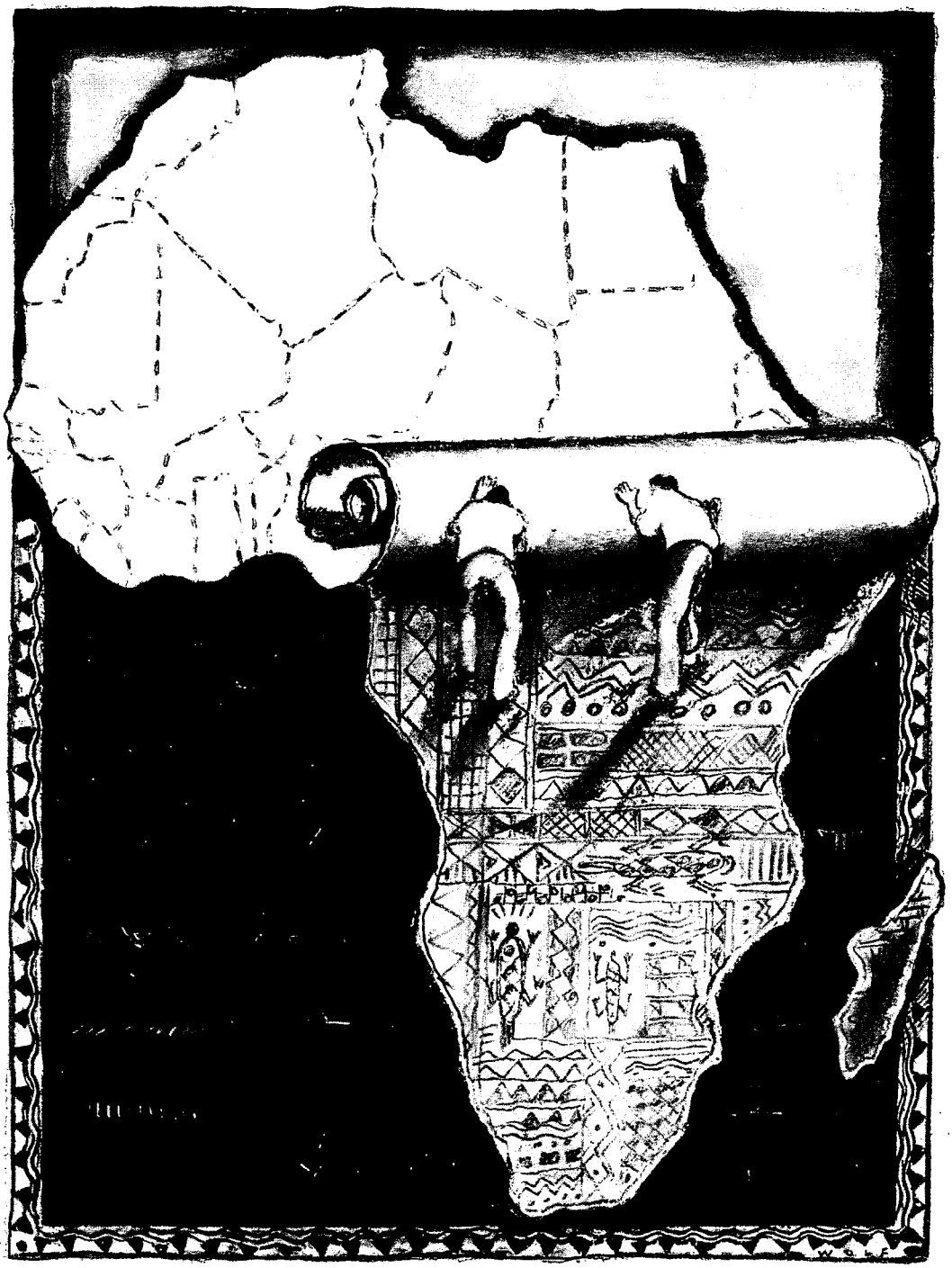


ILLUSTRATION BY ELIZABETH WOLF

Africa's Response to the Challenge

After independence Africans were eager to disavow tribalism as divisive. Unity was postulated in a way that assumed a mythical homogeneity amidst diversity. Kwame Nkrumah of Ghana outlawed parties organized on tribal or ethnic bases. Houphouet-Boigny of Côte d'Ivoire coopted ethnic groups through shrewd distribution of ministerial posts, civil service jobs, social services, and development projects. Julius Nyerere, a scion of tribal chieftaincy, stamped out tribalism by fostering nationalistic pride in Tanganyika and later, Tanzania, born out of the union with Zanzibar. Jommo Kenyatta of Kenya forged a delicate alliance of ethnic groups behind the dominance of his Kenyan African National Union party. In South Africa, apartheid recognized and stratified races and ethnicities to an unsustainable degree. Post-apartheid South Africa, however, remains poised between a racially, ethnically, and tribally blind democratic system and a proud ethnic self-assertiveness, represented and exploited by Zulu nationalists, spearheaded by the emotive leadership of Chief Buthelezi.

Throughout Africa, the goal of safeguarding unity within the colonial state has preserved the stability of colonial borders while generating ethnic tensions and violence within those borders. Sudan offers an extreme example. The dominant North, a hybrid of Arab and African racial, cultural, and religious elements, is trying to resolve its identity crisis by being more Arab and Islamic than its prototypes. Worse, this distorted self-perception, heightened by the agendas of political elites, is projected as the framework for unifying and integrating the country, generating a devastating zero-sum conflict between the Arab-Muslim North and the indigenously African South, whose modern leadership is predominantly Christian.

The decision of the Founding Fathers of the Organization of African Unity to respect the colonial borders established a normative principle that has been followed with remarkable success. Secession movements have met with strong resistance from the OAU. Katanga tried to break away from the Congo (which became Zaire, now back to the Democratic Republic of the Congo) but failed. The secessionist Biafran war in Nigeria also failed. Somalia's attempt to take

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

the Ogaden from Ethiopia was decisively thwarted. Southern Sudan struggled for 17 years to break away from the North and in the end settled for autonomy in 1972. When the fighting resumed in 1983, the stated goal was and remains the creation of a new Sudan that would be free from any discrimination based on race, ethnicity, culture, or religion.

Eritrea's breakaway from Ethiopia is seen not as a case of violating colonial borders, but of upholding them, since Eritrea had been a colony under Italian rule. Likewise, the de facto breakaway of Northern Somalia is seen as a restoration of colonial borders, since the North had been governed separately by the British. Even in the Sudan, often said to be a good candidate for partition, should the country be divided, the division might be rationalized as an extension of the British colonial policy that governed the Sudan as two separate entities, one Arab-Islamic and the other indigenous African with rudiments of Christian Western influences.

In most African countries, the determination to preserve national unity following independence provided the motivation behind one-party rule, excessive centralization of power, oppressive authoritarian regimes, and systematic violation of human rights and fundamental liberties. These in turn have generated a reaction, manifested in heightened tension and the demand for a second liberation. Managing ethnic diversity within the unity of the colonial borders is a challenge that African states are reluctant to face, but cannot wish away.

Ethiopia, after Eritrea's breakaway, can claim credit for being the only African country trying to confront head-on the challenge of tribalism or ethnicity by recognizing territorially based ethnic groups, granting them not only a large measure of autonomy, but also the constitutional right of self-determination, even to the extent of secession. Ethiopia's leaders assert emphatically that they are committed to the right of self-determination, wherever it leads. Less idealistically, it can be argued that giving the people the right to determine their destiny leads them to believe that their interests will be provided for, if only to give them a reason to opt for unity.

The only sustainable unity is that based on mutual understanding and agreement. Unfortunately, the normative framework for national unity in modern Africa is not the result of consensus. Except for post-apartheid South Africa, Africans won their independence without negotiating an internal social contract that would win and sustain national consensus. The constitutions for independence were laden with idealistic principles developed outside the continent. The regimes built on them lacked legitimacy and in most cases were soon overthrown with no remorse or regrets from the public. But these upheavals involved only a rotation of like-minded elites, or worse, military dictators, intent on occupying the seat of power vacated by the colonial masters. Such leaders soon became their colonial masters' images.

At the moment, for the overwhelming majority of African countries the quest for unity underscores the intensity of disunity. As long as the Africans avoid confronting the issue of ethnicity and fail to develop norms and means for managing diversity within the framework of unity, peace and stability will continue to elude the pluralistic state.

Models of Ethnic Configuration

African governments have responded to the challenge in varying ways, ranging from pragmatic management to blind neglect and catastrophic mismanagement. The particular form the ethnic policies of a country take may in large measure be dictated by the characteristics of its identity configuration.

A few states in Africa enjoy a high degree of homogeneity or, at least, a relatively inconsequential diversity. Botswana, for example, reflects exemplary cohesiveness, democracy, stability, and sustained growth.

Deprive a people of their ethnicity, their culture, and you deprive them of their sense of direction or purpose.

Most African countries, particularly those in West Africa (possibly excepting Nigeria), Kenya, and southern African countries (exclusive of South Africa), fall into a second category. These countries face significant ethnic pluralism that is nevertheless containable through an effective system of distribution that upholds the integrity and legitimacy of the state. The way the nations in this group perceive themselves is consonant with the self-perceptions of their component groups.

A third group of countries, including Zimbabwe, Namibia, and modern-day South Africa, suffers racial, ethnic, religious, or cultural divisions severe enough to require special arrangements to be mutually accommodating in an ambivalent form of unity in diversity. Burundi and Rwanda, as well as Sudan, are candidates for this category, though all also have aspects of the fourth, and final, category.

The fourth category, the zero-sum conflict situation, consists of states embroiled in acute crisis with no collective sense of identification, no shared values, and no common vision for the nation. The framework of the nation-state is perceived as an imposition by the colonial invaders, now perpetuated by

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

the dominant group whose identity defines the national character. Such definition might be explicit, as in apartheid South Africa, where race and ethnicity were factors in allocating or denying the rights of citizenship, or in the Sudan, where the identification of the country as Arab and Islamic carries inherent stratification and discrimination on racial, ethnic, and religious grounds. These conflicts are the most difficult to manage within the unity framework; depending on the particular circumstance of the case, they may call for fundamental restructuring and perhaps partition.

Policy Implications for Nationbuilding

At present, most African countries are addressing the racial and ethnic identity issues through a pacifying system of distribution and allocation—a form of ad hoc pragmatic management rather than a strategic approach. What makes the issue of identity particularly acute for the continent is that it touches not only on politics, but also on economics and the organizational capacity for a self-generating and sustainable development from within.

There are four policy options for managing pluralistic identities. One is to create a national framework with which all can identify without any distinction based on race, ethnicity, tribe, or religion. This option, of course, best suits those countries that are highly homogeneous. The second option is to create a pluralistic framework to accommodate nations that are racially, ethnically, culturally, or religiously diverse. Under this option, probably a federal arrangement, groups would accommodate each other on the basis of the principle of live and let live, but with a more uniting commitment to the common purpose of national identification. In the third case, for more seriously divided countries, some form of power sharing combined with decentralization, with identities being geographically defined, may be the answer. In the zero-sum conflict situations, federalism would expand into confederalism, paradoxically trying to reconcile unity with separation. Where even this degree of accommodation is not workable, and where territorial configurations permit, partition ought to be accepted.

The Role of the International Community

How are these options to be brought about? Deciding which option to adopt is, of course, in the first place part of the sovereign right of the people of the country. But regional and international actors also have a responsibility that cannot be abdicated in the name of national sovereignty. By its very nature, sovereignty implies a tension between the demand for internal solutions and the need for corrective remedies from the outside. In other words, the responsibilities of sovereignty require both internal and external accountability, which are inherently at odds, especially since the need for external involvement is commensurate with the failure of internal systems. Given the ambivalence of the international system about intervention, this responsibility should belong first to the subregional and regional actors, with the international community, through the United Nations, as the ultimate resort.

The interconnectedness of the conflicts of neighboring countries means that preventing, managing, or resolving conflicts is becoming recognized as a matter of interest and concern not only to the countries directly involved, but also to the region as a whole. Regional awakening to the common threat of internal conflict is still nascent, but the importance of the shared threat is being increasingly realized, especially in view of the tendency toward isolationism in Europe and the United States, the only powers still capable of effectively intervening for humanitarian reasons or for the cause of peace, security, and stability in other parts of the world.

Reconciling Two Conflicting Paths

Final accountability for the responsibilities of sovereignty must ultimately fall on the international community, more specifically the United Nations. The intervention of international financial institutions in the affairs of sovereign countries to ensure more efficient management of their economies has now become a truism. International concern with issues of governance, such as democracy and respect for fundamental human rights, has also become widely accepted, despite the lingering resistance of vulnerable regimes. Beyond the issue of protection of minorities, long recognized as a legitimate concern for the international community, the politics and conflicts of identity and their impact on the prospects for peace, stability, development, and nation building must also be recognized as critical items on the agenda of a responsible and accountable sovereignty.

Insofar as the modern African state is the creation of European conquest, restructuring the continent, linking it to the international system, and reconceptualizing and reconstituting the state will require the cooperation of Africa's global partners. Outside actors can offer an objective and impartial perspective that can be pivotal to balancing the concerns of the internal actors. In addition, the international legitimacy of any new arrangements, which is necessary for building support from outside sources, can best be ensured by enlisting international partners in the search for effective solutions to these internal crises.

Post-colonial Africa stands poised between rediscovering its roots—its indigenous values, institutions, and experiences—and pursuing the logic of the colonial state in the context of universalizing modernity, primarily based on Western experience. The resulting tensions cannot be easily resolved. But an eclectic process that fashions a system in which ethnic groups can play a constructive role in the modern African state could significantly reduce the tension, foster cooperation, and facilitate the process of nation building. ■

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

Despite Recent Reverses, Japan Is Still A

A U.S.-JAPAN

Judging from the American press, Japan has become yesterday's problem. With the collapse of Japanese stock and real estate prices in the early 1990s, very slow economic growth from 1992 to 1995, and revelations of large amounts of bad debt in the banking sector, longstanding U.S. concerns about trade with Japan seem simply to have slipped the minds of many Americans. Even the Clinton administration, which pursued a high-profile and active stance on trade issues with Japan in its first term, shows little inclination to continue a high-pressure campaign now.

But though Japan no longer seems an unstoppable juggernaut, it nevertheless remains one of the world's leading industrial nations. Its economy is recovering: growth was 3.6 percent in 1996 (outpacing the United States) and is likely to be at least 2 percent this year. Japan also remains a big part of U.S. trade. In 1995, Japan was the second largest U.S. export market, taking 11 percent of all U.S. exports, and was the source of 15 percent of U.S. imports. And leading Japanese corporations are still the chief global competitors in many industries for American firms. Japanese markets are large, affluent, and growing—all reasons for American firms to be involved in them.

To be sure, these individual trade problems are not linked in any major way to macroeconomic balances. Solving market access problems will not materially alter Japan's global trade surplus or the bilateral imbalance between Japan and the United States. Large declines in the value of the yen against the dollar in the past two years will result in sharp increases in Japanese trade surpluses this year and next. But those surpluses should not be the reason for increasing pressure on trade issues. Market access issues have a separate justification, growing out of the intellectual concept of free trade and the official support that notion has garnered from major nations—including Japan.

An active market-access approach to trade with Japan will involve disputes and tension. But more open markets increase economic flows of trade and investment and ultimately strengthen the U.S.-Japan relationship. Temporary antagonisms that flare during trade disputes are less dangerous than long-term ill will engendered by a lack of access to many Japanese markets. Though the Clinton administration shows a certain amount of fatigue on Japan after four active and contentious years, it should nevertheless persevere. The following modest agenda would keep trade issues moving forward.

Running through these suggestions is an implicit theme—the need for more fiscal and human resources. Only a handful of people work actively on these issues within the U.S. government. Too often in the past the U.S. government has been at a disadvantage when negotiating with the many, well-prepared officials representing the Japanese government. Reinforcing the U.S. team is not a major financial issue. The size and importance of Japanese markets to American businesses and the seriousness of some of the problems justify the added expense and effort.

WTO

In June 1996, the United States Trade Representative (USTR) chose to take a dispute over access to the color film market to the World Trade Organization. The dispute, a landmark case, raises fundamental questions about the nature of industrial policy in Japan, the continuing existence of opaque and unusual regulatory controls over the distribution sector, and the ability of the WTO to handle such complex issues. In essence the case

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

Huge Market That Needs To Be More Open

BY EDWARD J. LINCOLN

AGENDA

argues that Japanese industrial policy operated informally to keep the color film market closed despite agreements to eliminate quotas and reduce tariffs. It also argues that regulations in Japan were not designed or administered in a manner to guarantee national treatment for foreign firms, and that administrative processes were not transparent. The Japanese government will probably settle with the United States before the final decision in October rather than risk losing and thereby setting a precedent. But even if a definitive decision on the case is unlikely, the U.S. government should pursue it vigorously and bring more cases to the WTO that challenge the impact of industrial policy in Japan on market access.

The WTO provides additional advantages. If or when Japan loses a case, the demand for change (or authorization of U.S. retaliation) comes from a multilateral source, helping to diffuse Japanese rancor, which is usually directed solely against the United States. The WTO also promotes useful coalition-building (for example, European Union cooperation on the current color film case). Convincing a multilateral panel in Geneva of the legitimacy of U.S. complaints about market access in Japan is obviously harder than simply convincing U.S. government agencies in Washington. But the detailed exposure of Japanese trade barriers in a public forum, as is happening with the color film case, is critical to gaining international understanding and support for American trade policy toward Japan. Therefore, a key aspect of policy should be to make more active use of the WTO to pursue trade problems with Japan.

BILATERAL CASES

Not all problems concerning market access in Japan fit within the framework of the WTO. Sometimes the industries or the behavior involved are not covered by WTO rules. Sometimes the dispute concerns creating new rules for market access rather than disagreement over behavior under past commitments. Except when large multilateral negotiating rounds are under way, the WTO assumes that nations will engage in such negotiations bilaterally, with the stipulation that the results be applied on a most-favored-nation basis to other WTO members. U.S.-Japan bilateral negotiations meet this requirement.

In bilateral cases the key is finding and applying leverage in the form of costs to Japanese commercial interests that can be imposed when negotiations fail. Why should a sovereign nation comply with requests for market liberalization in the absence of international rules? Sometimes governments agree because they, too, desire to sweep away market impediments, to satisfy domestic consumer and business pressure for lower costs and greater efficiency. Rarely, however, do matters happen this way in Japan. There the voice of consumers is weak. Even businesses harmed by protection often fail to press hard for liberalization with their own government—as has been the case in the current dispute over harbor services, where the collusive system raises costs to Japanese shipping companies as well as American ones. Japan's government does, however, respond when faced with a realistic probability of American retaliation in the form of punitive actions against Japanese economic interests in the United States. An early step in any non-WTO bilateral issue must be to determine what leverage of this sort can be brought to bear. Among potential sources of leverage are section 301 (although its use is problematic in the wake of the GATT Uruguay round agreement), regulatory

Edward J. Lincoln is a senior fellow in the Brookings Foreign Policy Studies program. He was special economic advisor to Ambassador Walter Mondale in Japan during 1994–96.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

authority, federal contracting rules, and even antitrust prosecution. If these tools are to be effective, they must be used on occasion. The recent decision of the Federal Maritime Commission to impose fees on Japanese shipping lines using U.S. ports, for example, spurred the Japanese government to address the question of restrictive practices at Japanese ports.

MONITORING AGREEMENTS

Results matter. Trade agreements need to be fully implemented after they are negotiated, and they should lead to increased market opportunities for foreign firms. Setting targets for foreign penetration, as in the case of semiconductors, may be unavoidable when all other approaches fail, though adopting managed trade as a general principle is neither desirable economically nor feasible politically. As a general principle, vigorously monitoring implementation and outcomes without preconditions can help convince the Japanese government that implementation must occur in good faith.

Monitoring does not require a commitment written into bilateral agreements. The Clinton administration spent too much negotiating time in the first term haggling over the terminology for these commitments, especially over language expressing the goal of increased sales and market share for foreign products. What matters most is that implementation be watched closely, statistical data collected, and analysis done on the causes of market outcomes. Should the statistical evidence suggest that problems still exist, the government can determine what approach is needed, such as negotiations to strip away other impediments.

[illegible] ON TRADE

The public message on bilateral trade issues, especially in a vigorous market-access campaign, should remain low-key. There is no need to portray the trade relationship in dramatic terms, nor to tout successful negotiations as great victories. Even restrained rhetoric, of course, will garner considerable unfavorable attention in the Japanese media. But there is no need to contribute unnecessarily to the Japanese perception of excessive pressure.

Accompanying the low-key rhetoric should be a steady stream of factual information. Simply responding to media questions or holding (infrequent) formal press conferences leaves U.S. policymakers on the defensive. In the color film case, release of the brief filed in Geneva last February provided the media and public with great detail on American allegations, carefully documenting factual evidence and how the Japanese government and industry worked to impede market access. That approach should be the model for all trade disputes.

JAPANESE FIRMS [illegible]

Continued Japanese direct investment abroad raises new issues for U.S. government scrutiny. Are collusive patterns of behavior at home being replicated abroad? To what extent do large amounts of bilateral foreign aid grease the way for Japanese firms investing in developing countries in Asia? Are American firms disadvantaged by such behavior? To what extent does the increase in Japanese imports represent purchases from manufacturing subsidiaries abroad rather than from independent foreign firms (implying that Japanese markets are not really more open despite rising imports)? These questions do not yet have clear answers, but they will become increasingly important. Focusing exclusively on the bilateral context will miss many of these issues, ranging from questions of preferential access in developing country markets to the rather unrestrained movement of Japanese firms into the Burmese market (in contrast to both Japan's official stance on human rights in Burma and U.S. policy objectives). These issues are particularly salient in Asia, which is now absorbing a rising share of the foreign direct investment of Japanese firms.

[illegible] THEMES

Large overarching themes, such as the Market-Oriented Sector Selective (MOSS) talks of 1985–86, the Structural Impediments (SI) talks of 1989–90, and the Framework Agreement of 1993–96, are to be avoided. They lead the Japanese government to assume that the Americans have been gripped by another short-term enthusiasm—one that they can ride out with minimal concessions. They also oversimplify U.S. policy, which should be just as complex and multifaceted as the relationship itself.

One particular organizing theme to avoid is deregulation. The two governments have already agreed to upgrade the level of dialogue on deregulation. In theory, this will engage both sides in discussing an issue that has public support in Japan. But deregulation is unlikely to proceed with any vigor in Japan, and a primary focus on it would trap the administration in a discussion of an extraordinarily broad topic, which the Japanese government would try to keep at a high level of generality. The administration should certainly remain engaged on this issue, but not as the central, high-profile focus of policy. Most deregulation issues are better pursued when they arise in the context of particular trade issues, as with the color film dispute (which challenges the existence of the Large Scale Retail Store Law). At least the administration appears to have chosen to discuss only a few issues under the rubric of deregulation, based on existing sectoral access problems.

SHORT-TERM TENSION, LONG-TERM [illegible]

The approach sketched above would continue or accelerate progress in lowering trade barriers in Japan. It will certainly yield further tension, since it proposes an active pursuit of market access problems that the Japanese government will vigorously oppose at the negotiating table and in the media. Tension is unavoidable, but it can be managed with greater attention to the public message. The long-run gain to the bilateral relationship from greater market openness is a compelling reason to accept the short-term perceptions of tension (and any temporary harm to other aspects of the bilateral relationship) that this active agenda would bring about. ■

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

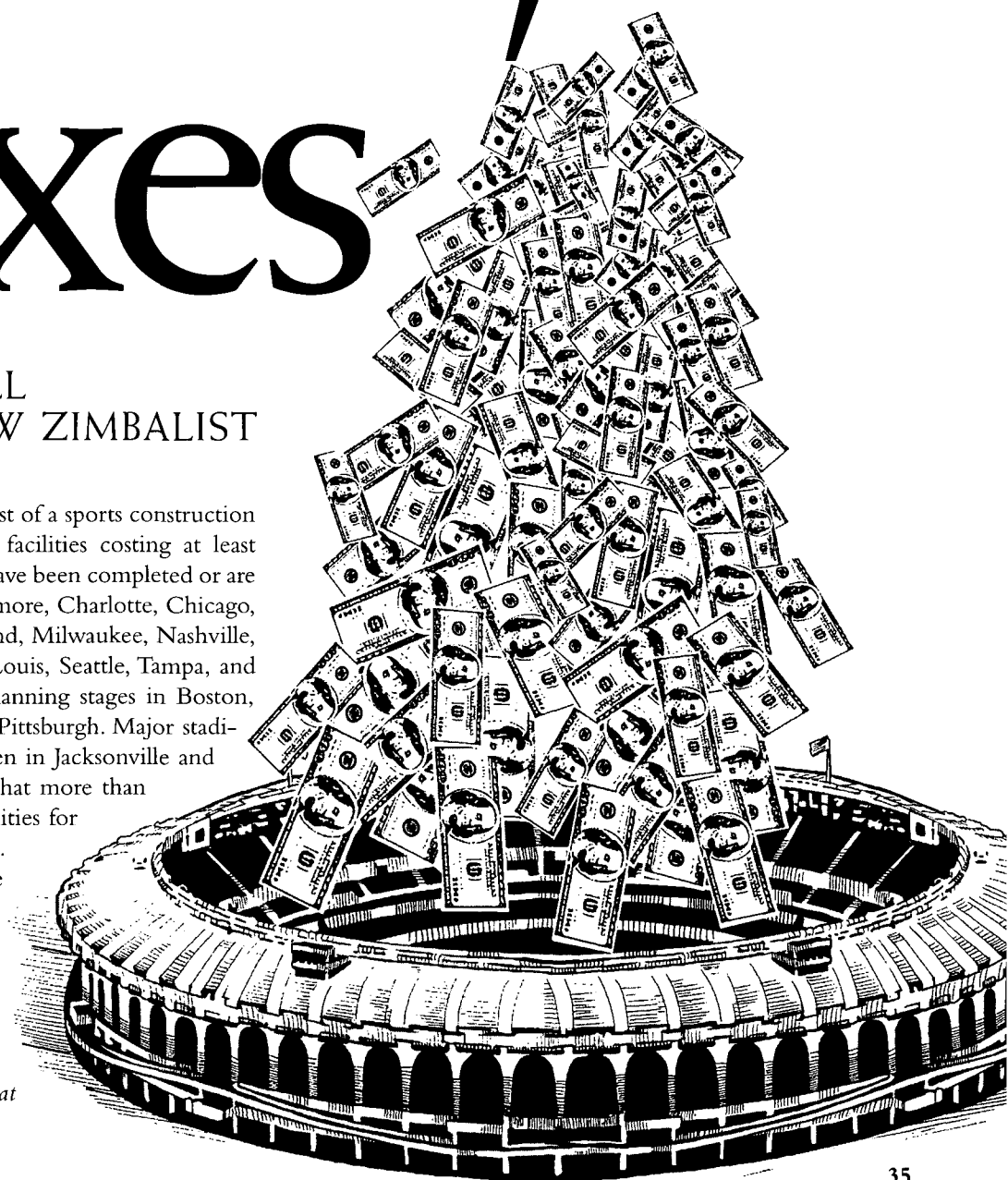
Sports, Jobs, & Taxes

STADIUMS: WORTH THE COST?

BY ROGER G. NOLL AND ANDREW ZIMBALIST

America is in the midst of a sports construction boom. New sports facilities costing at least $200 million each have been completed or are under way in Baltimore, Charlotte, Chicago, Cincinnati, Cleveland, Milwaukee, Nashville, San Francisco, St. Louis, Seattle, Tampa, and Washington, D.C., and are in the planning stages in Boston, Dallas, Minneapolis, New York, and Pittsburgh. Major stadium renovations have been undertaken in Jacksonville and Oakland. Industry experts estimate that more than $7 billion will be spent on new facilities for professional sports teams before 2006.

Most of this $7 billion will come from public sources. The subsidy starts with the federal government, which allows state and local gov-



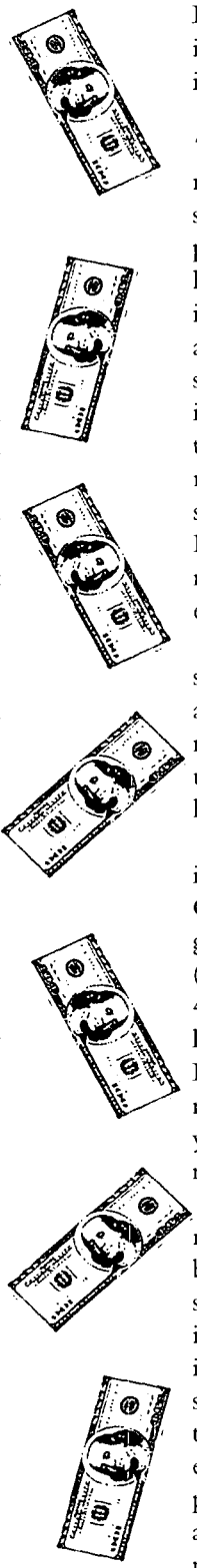
Roger G. Noll is professor of economics at Stanford University. Andrew Zimbalist is professor of economics at Smith College.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

ernments to issue tax-exempt bonds to help finance sports facilities. Tax exemption lowers interest on debt and so reduces the amount that cities and teams must pay for a stadium. Since 1975, the interest rate reduction has varied between 2.4 and 4.5 percentage points. Assuming a differential of 3 percentage points, the discounted present value loss in federal taxes for a $225 million stadium is about $70 million, or more than $2 million a year over a useful life of 30 years. Ten facilities built in the 1970s and 1980s, including the Superdome in New Orleans, the Silverdome in Pontiac, the now-obsolete Kingdome in Seattle, and Giants Stadium in the New Jersey Meadowlands, each cause an annual federal tax loss exceeding $1 million.

State and local governments pay even larger subsidies than Washington. Sports facilities now typically cost the host city more than $10 million a year. Perhaps the most successful new baseball stadium, Oriole Park at Camden Yards, costs Maryland residents $14 million a year. Renovations aren't cheap either: the net cost to local government for refurbishing the Oakland Coliseum for the Raiders was about $70 million.

Most large cities are willing to spend big to attract or keep a major league franchise. But a city need not be among the nation's biggest to win a national competition for a team, as shown by the NBA's Utah Jazz's Delta Center in Salt Lake City and the NFL's Houston Oilers' new football stadium in Nashville.



Why Cities Subsidize Sports

The economic rationale for cities' willingness to subsidize sports facilities is revealed in the campaign slogan for a new stadium for the San Francisco 49ers: "Build the Stadium—Create the Jobs!" Proponents claim that sports facilities improve the local economy in four ways. First, building the facility creates construction jobs. Second, people who attend games or work for the team generate new spending in the community, expanding local employment. Third, a team attracts tourists and companies to the host city, further increasing local spending and jobs. Finally, all this new spending has a "multiplier effect" as increased local income causes still more new spending and job creation. Advocates argue that new stadiums spur so much economic growth that they are self-financing: subsidies are offset by revenues from ticket taxes, sales taxes on concessions and other spending outside the stadium, and property tax increases arising from the stadium's economic impact.

Unfortunately, these arguments contain bad economic reasoning that leads to overstatement of the benefits of stadiums. Economic growth takes place when a community's resources—people, capital investments, and natural resources like land—become more productive. Increased productivity can arise in two ways: from economically beneficial specialization by the community for the purpose of trading with other regions or from local value added that is higher than other uses of local workers, land, and investments. Building a stadium is good for the local economy only if a stadium is the most productive way to make capital investments and use its workers.

In our forthcoming Brookings book, *Sports, Jobs, and Taxes*, we and 15 collaborators examine the local economic development argument from all angles: case studies of the effect of specific facilities, as well as comparisons among cities and even neighborhoods that have and have not sunk hundreds of millions of dollars into sports development. In every case, the conclusions are the same. A new sports facility has an extremely small (perhaps even negative) effect on overall economic activity and employment. No recent facility appears to have earned anything approaching a reasonable return on investment. No recent facility has been self-financing in terms of its impact on net tax revenues. Regardless of whether the unit of analysis is a local neighborhood, a city, or an entire metropolitan area, the economic benefits of sports facilities are de minimus.

As noted, a stadium can spur economic growth if sports is a significant export industry—that is, if it attracts outsiders to buy the local product and if it results in the sale of certain rights (broadcasting, product licensing) to national firms. But, in reality, sports has little effect on regional net exports.

Sports facilities attract neither tourists nor new industry. Probably the most successful export facility is Oriole Park, where about a third of the crowd at every game comes from outside the Baltimore area. (Baltimore's baseball exports are enhanced because it is 40 miles from the nation's capital, which has no major league baseball team.) Even so, the net gain to Baltimore's economy in terms of new jobs and incremental tax revenues is only about $3 million a year—not much of a return on a $200 million investment.

Sports teams do collect substantial revenues from national licensing and broadcasting, but these must be balanced against funds leaving the area. Most professional athletes do not live where they play, so their income is not spent locally. Moreover, players make inflated salaries for only a few years, so they have high savings, which they invest in national firms. Finally, though a new stadium increases attendance, ticket revenues are shared in both baseball and football, so that part of the revenue gain goes to other cities. On balance, these factors are largely offsetting, leaving little or no net local export gain to a community.

One promotional study estimated that the local annual economic impact of the Denver Broncos was nearly $120 million; another estimated that the com-

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

bined annual economic benefit of Cincinnati's Bengals and Reds was $245 million. Such promotional studies overstate the economic impact of a facility because they confuse gross and net economic effects. Most spending inside a stadium is a substitute for other local recreational spending, such as movies and restaurants. Similarly, most tax collections inside a stadium are substitutes: as other entertainment businesses decline, tax collections from them fall.

Promotional studies also fail to take into account differences between sports and other industries in income distribution. Most sports revenue goes to a relatively few players, managers, coaches, and executives who earn extremely high salaries—all well above the earnings of people who work in the industries that are substitutes for sports. Most stadium employees work part time at very low wages and earn a small fraction of team revenues. Thus, substituting spending on sports for other recreational spending concentrates income, reduces the total number of jobs, and replaces full-time jobs with low-wage, part-time jobs.

A second rationale for subsidized stadiums is that stadiums generate more local consumer satisfaction than alternative investments. There is some truth to this argument. Professional sports teams are very small businesses, comparable to large department or grocery stores. They capture public attention far out of proportion to their economic significance. Broadcast and print media give so much attention to sports because so many people are fans, even if they do not actually attend games or buy sports-related products.

A professional sports team, therefore, creates a "public good" or "externality"—a benefit enjoyed by consumers who follow sports regardless of whether they help pay for it. The magnitude of this benefit is unknown, and is not shared by everyone; nevertheless, it exists. As a result, sports fans are likely to accept higher taxes or reduced public services to attract or keep a team, even if they do not attend games themselves. These fans, supplemented and mobilized by teams, local media, and local interests that benefit directly from a stadium, constitute the base of political support for subsidized sports facilities.

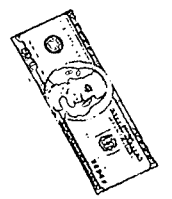
The Role of Monopoly Leagues

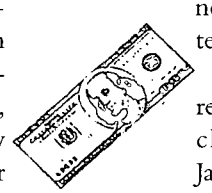
While sports subsidies might flow from externalities, their primary cause is the monopolistic structure of sports. Leagues maximize their members' profits by keeping the number of franchises below the number of cities that could support a team. To attract teams, cities must compete through a bidding war, whereby each bids its willingness to pay to have a team, not the amount necessary to make a team viable.

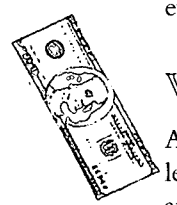
Monopoly leagues convert fans' (hence cities') willingness to pay for a team into an opportunity for teams to extract revenues. Teams are not required to take advantage of this opportunity, and in two cases—the Charlotte Panthers and, to a lesser extent, the San Francisco Giants—the financial exposure of the city has been the relatively modest costs of site acquisition and infrastructural investments. But in most cases, local and state governments have paid over $100 million in stadium subsidy, and in some cases have financed the entire enterprise.

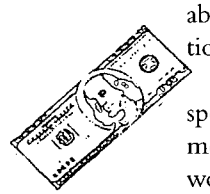
A new sports facility has an extremely small (perhaps even negative) effect on overall economic activity and employment.

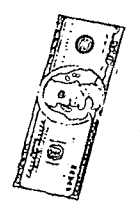
The tendency of sports teams to seek new homes has been intensified by new stadium technology. The rather ordinary cookie-cutter, multipurpose facility of the 1960s and 1970s has given way to the elaborate, single-sport facility that features numerous new revenue opportunities: luxury suites, club boxes, elaborate concessions, catering, signage, advertising, theme activities, and even bars, restaurants, and apartments with a view of the field. A new facility now can add $30 million annually to a team's revenues for a few years after the stadium opens.











Because new stadiums produce substantially more revenues, more cities are now economically viable franchise sites—which explains why Charlotte, Jacksonville, and Nashville have become NFL cities. As more localities bid for teams, cities are forced to offer ever larger subsidies.

What Can Be Done?

Abuses from exorbitant stadium packages, sweetheart leases, and footloose franchises have left many citizens and politicians crying foul. What remedy, if any, is available to curb escalating subsidies and to protect the emotional and financial investments of fans and cities?

In principle, cities could bargain as a group with sports leagues, thereby counterbalancing the leagues' monopoly power. In practice, this strategy is unlikely to work. Efforts by cities to form a sports-host association have failed. The temptation to cheat by secretly negotiating with a mobile team is too strong to preserve concerted behavior.

Another strategy is to insert provisions in a facility lease that deter team relocation. Many cities have tried this approach, but most leases have escape clauses that allow the team to move if attendance falls too low or if the facility is not in state-of-the-art condition. Other teams have provisions requiring them to pay tens of millions of dollars if they vacate a facility prior to lease expiration, but these provisions also come with qualify-

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

ing covenants. Of course, all clubs legally must carry out the terms of their lease, but with or without these safeguard provisions, teams generally have not viewed their lease terms as binding. Rather, teams claim that breach of contract by the city or stadium authority releases them from their obligations. Almost always these provisions do not prevent a team from moving.

Some leases grant the city a right of first refusal to buy the team or to designate who will buy it before the team is relocated. The big problem here is the price. Owners usually want to move a team because it is worth more elsewhere, either because another city is building a new facility with strong revenue potential or because another city is a better sports market. If the team is worth, say, $30 million more if it moves, what price must the team accept from local buyers? If it is the market price (its value in the best location), an investor in the home city would be foolish to pay $30 million more for the franchise than it is worth there. If the price is the value of the franchise in its present home, the old owner is deprived of his property rights if he cannot sell to the highest bidder. In practice, these provisions typically specify a right of first refusal at market price, which does not protect against losing a team.

Cities trying to hold on to a franchise can also invoke eminent domain, as did Oakland when the Raiders moved to Los Angeles in 1982 and Baltimore when the Colts moved to Indianapolis in 1984. In the Oakland case, the California Court of Appeals ruled that condemning a football franchise violates the commerce clause of the U.S. Constitution. In the Colts case, the condemnation was upheld by the Maryland Circuit Court, but the U.S. District Court ruled that Maryland lacked jurisdiction because the team had left the state by the time the condemnation was declared. Eminent domain, even if constitutionally feasible, is not a promising vehicle for cities to retain sports teams.

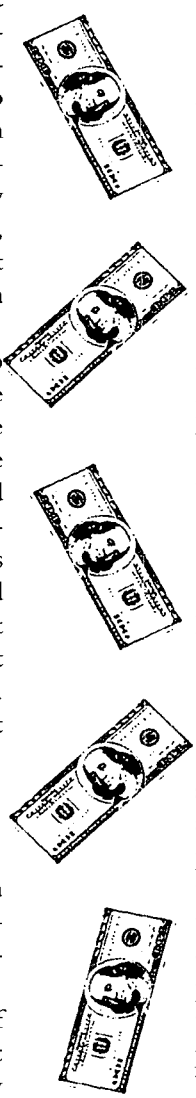
Ending Federal Subsidies

Whatever the costs and benefits to a city of attracting a professional sports team, there is no rationale whatsoever for the federal government to subsidize the financial tug-of-war among the cities to host teams.

In 1986, Congress apparently became convinced of the irrationality of granting tax exemptions for interest on municipal bonds that financed projects primarily benefiting private interests. The 1986 Tax Reform Act denies federal subsidies for sports facilities if more than 10 percent of the debt service is covered by revenues from the stadium. If Congress intended that this would reduce sports subsidies, it was sadly mistaken. If anything, the 1986 law increased local subsidies by cutting rents below 10 percent of debt service.

Last year Senator Daniel Patrick Moynihan (D-NY), concerned about the prospect of a tax exemption for a debt of up to $1 billion for a new stadium in New York, introduced a bill to eliminate tax-exempt financing for professional sports facilities and thus eliminate federal subsidies of stadiums. The theory behind the bill is that raising a city's cost from a stadium giveaway would reduce the subsidy. Although cities might respond this way, they would still compete among each other for scarce franchises, so to some extent the likely effect of the bill is to pass higher interest charges on to cities, not teams.

> Sports leagues remain unregulated monopolies with de facto immunity from federal antitrust prosecution.



Antitrust and Regulation

Congress has considered several proposals to regulate team movement and league expansion. The first came in the early 1970s, when the Washington Senators left for Texas. Unhappy baseball fans on Capitol Hill commissioned an inquiry into professional sports. The ensuing report recommended removing baseball's antitrust immunity, but no legislative action followed. Another round of ineffectual inquiry came in 1984–85, following the relocations of the Oakland Raiders and Baltimore Colts. Major league baseball's efforts in 1992 to thwart the San Francisco Giants' move to St. Petersburg again drew proposals to withdraw baseball's cherished antitrust exemption. As before, nothing came of the congressional interest. In 1995–96, inspired by the departure of the Cleveland Browns to Baltimore, Representative Louis Stokes from Cleveland and Senator John Glenn of Ohio introduced a bill to grant the NFL an antitrust exemption for franchise relocation. This bill, too, never came to a vote.

The relevance of antitrust to the problem of stadium subsidies is indirect but important. Private antitrust actions have significantly limited the ability of leagues to prevent teams from relocating. Teams relocate to improve their financial performance, which in turn improves their ability to compete with other teams for players and coaches. Hence, a team has an incentive to prevent competitors from relocating. Consequently, courts have ruled that leagues must have "reasonable" relocation rules that preclude anticompetitive denial of relocation. Baseball, because it enjoys an antitrust exemption, is freer to limit team movements than the other sports.

Relocation rules can affect competition for teams because, by making relocation more difficult, they can

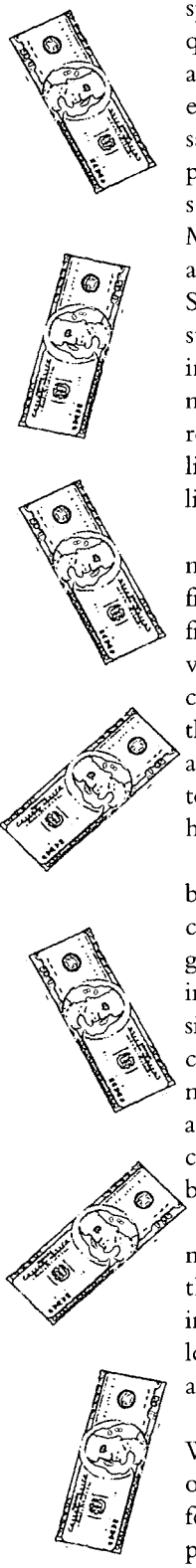
LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

limit the number of teams (usually to one) that a city is allowed to bid for. In addition, competition among cities for teams is further intensified because leagues create scarcity in the number of teams. Legal and legislative actions that change relocation rules affect which cities get existing teams and how much they pay for them, but do not directly affect the disparity between the number of cities that are viable locations for a team and the number of teams. Thus, expansion policy raises a different but important antitrust issue.

As witnessed by the nearly simultaneous consideration of creating an antitrust exemption for football but denying one for baseball on precisely the same issue of franchise relocation, congressional initiatives have been plagued by geographical chauvinism and myopia. Except for representatives of the region affected, members of Congress have proven reluctant to risk the ire of sports leagues. Even legislation that is not hampered by blatant regional self-interest, such as the 1986 Tax Reform Act, typically is sufficiently riddled with loopholes to make effective implementation improbable. While arguably net global welfare is higher when a team relocates to a better market, public policy should focus on balancing the supply and demand for sports franchises so that all economically viable cities can have a team. Congress could mandate league expansion, but that is probably impossible politically. Even if such legislation were passed, deciding which city deserves a team is an administrative nightmare.

A better approach would be to use antitrust to break up existing leagues into competing business entities. The entities could collaborate on playing rules and interleague and postseason play, but they would not be able to divvy up metropolitan areas, establish common drafts or player market restrictions, or collude on broadcasting and licensing policy. Under these circumstances no league would be likely to vacate an economically viable city, and, if one did, a competing league would probably jump in. Other consumer-friendly consequences would flow from such an arrangement. Competition would force ineffective owners to sell or go belly up in their struggle with better managed teams. Taxpayers would pay lower local, state, and federal subsidies. Teams would have lower revenues, but because most of the costs of a team are driven by revenues, most teams would remain solvent. Player salaries and team profits would fall, but the number of teams and player jobs would rise.

Like Congress, the Justice Department's Antitrust Division is subject to political pressures not to upset sports. So sports leagues remain unregulated monopolies with de facto immunity from federal antitrust prosecution. Others launch and win antitrust complaints against sports leagues, but usually their aim is membership in the cartel, not divestiture, so the problem of too few teams remains unsolved.



Citizen Action

The final potential source of reform is grassroots disgruntlement that leads to a political reaction against sports subsidies. Stadium politics has proven to be quite controversial in some cities. Some citizens apparently know that teams do little for the local economy and are concerned about using regressive sales taxes and lottery revenues to subsidize wealthy players, owners, and executives. Voters rejected public support for stadiums on ballot initiatives in Milwaukee, San Francisco, San Jose, and Seattle, although no team has failed to obtain a new stadium. Still, more guarded, conditional support from constituents can cause political leaders to be more careful in negotiating a stadium deal. Initiatives that place more of the financial burden on facility users—via revenues from luxury or club boxes, personal seat licenses (PSLs), naming rights, and ticket taxes—are likely to be more popular.

Unfortunately, citizen resistance notwithstanding, most stadiums probably cannot be financed primarily from private sources. In the first place, the use of money from PSLs, naming rights, pouring rights, and other private sources is a matter to be negotiated among teams, cities, and leagues. The charges imposed by the NFL on the Raiders and Rams when they moved to Oakland and St. Louis, respectively, were an attempt by the league to capture some of this (unshared) revenue, rather than have it pay for the stadium.

Second, revenue from private sources is not likely to be enough to avoid large public subsidies. In the best circumstance, like the NFL's Charlotte Panthers, local governments still pay for investments in supporting infrastructure, and Washington still pays an interest subsidy for the local government share. And the Charlotte case is unique. No other stadium project has raised as much private revenue. At the other extreme is the disaster in Oakland, where a supposedly break-even financial plan left the community $70 million in the hole because of cost overruns and disappointing PSL sales.

Third, despite greater citizen awareness, voters still must cope with a scarcity of teams. Fans may realize that subsidized stadiums regressively redistribute income and do not promote growth, but they want local teams. Alas, it is usually better to pay a monopoly an exorbitant price than to give up its product.

Prospects for cutting sports subsidies are not good. While citizen opposition has had some success, without more effective intercity organizing or more active federal antitrust policy, cities will continue to compete against each other to attract or keep artificially scarce sports franchises. Given the profound penetration and popularity of sports in American culture, it is hard to see an end to rising public subsidies of sports facilities. ■

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

EPA's Proposed Air Quality Standards

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

Clean Air Sense

BY LESTER B. LAVE

Three decades of debate about clean air regulation have done little to temper the acrimonious tone of the discussion. When the Environmental Protection Agency proposed last winter to tighten the National Ambient Air Quality standards for ozone and small particles, angry charges again rang out on all sides. With billions of dollars, millions of illnesses, and tens of thousands of premature deaths at issue, it could hardly be otherwise.

Rather than each side telling us what is in its special interest, I propose to explore what is in the public

Lester B. Lave is professor of economics at Carnegie-Mellon University.

The Costly Pursuit of the Impossible

BY ROBERT W. CRANDALL

No one should have been surprised when Environmental Protection Agency Administrator Carol Browner proposed to tighten the National Ambient Air Quality Standards (NAAQS) for ozone and particulate matter. Nor should it have occasioned surprise when the Office of Management and Budget chose not to challenge the proposal despite the president's 1993 executive order requiring a demonstration that the benefits of any new regulatory proposal exceed its costs. One might have been surprised to find, however, that the EPA itself admitted that the benefits of additional controls on one of the pollutants are far less than their additional cost—and even more surprised that EPA now would admit that even its current standard for this

Robert W. Crandall is a senior fellow in the Brookings Economic Studies program.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

interest by examining the estimated benefits and costs of the proposed new regulations and probing the uncertainties involved.

Ozone is formed when organic compounds and nitrogen oxides emitted by motor vehicles and industrial sources (and, yes, trees) react in the summer atmosphere. Small particles result, for the most part, when gases from industrial and utility plants change chemically in the atmosphere. Almost no large urban areas in the United States are in compliance with the current ozone standard; many smaller population centers in the West, South, and Northeast would become noncompliant under the proposed standard. Short of exporting people and jobs, areas such as Los Angeles may never attain the proposed ozone standard. Compliance with both the current and proposed suspended particle standards is much less of a problem.

Industry says it will be hurt by the abatement costs and that its competitiveness will suffer. It charges EPA Administrator Carol Browner with being arbitrary in setting the standards and with relying on inadequate science. Environmentalists counter that the revised standards are long overdue, that scientists have found that the new standards will improve the public's health, and that EPA should tighten the standards even further given scientific knowledge about the effects of ozone on health. Prominent scientists have added to the cacophony by praising the ozone standard for the quality of the underlying science while suggesting that the small particle standard be delayed until the science is shored up.

Congress gave one definition of the "public interest" in the 1970 Clean Air Act. Subsequent presidential directives have given another.

Congress gave one definition of the "public interest" in the 1970 Clean Air Act when it instructed the EPA administrator to set air quality standards that protect the public health with an adequate margin of safety. The lawmakers made no mention of the costs of compliance, and EPA administrators claim that they do not look at those costs.

Presidents Ronald Reagan, George Bush, and Bill Clinton have taken a different view of the criteria by which to judge pollutant fails a benefit-cost test. More frightening, however, is the fact that EPA now admits that full compliance with either new proposed standard is virtually impossible; therefore, its proposals for each are impossible dreams backed by the threat of sanctions on the states that do not achieve those dreams.

This overreaching in the name of protecting us from the evils of an advanced post–industrial society graphically illustrates the need for regulatory reform of the variety unsuccessfully championed by Senator Robert Dole in the 104th Congress, requiring that all regulatory activities of the federal government pass a benefit-cost test. It also shows how difficult it is to bring rational debate to the process of regulating against threats to health and safety. Challenging an environmental proposal on the basis that its benefits do not outweigh its costs is almost as difficult as challenging the method for indexing Social Security benefit levels. Still, it is essential that we try, if only to lay the groundwork for a more rational approach to such problems in the millennium ahead.

The Pollutants

Lester Lave has already described the two pollutants at the center of this debate. Controlling photochemical smog, or its primary constituent, ozone, requires controls on volatile organic compounds (hydrocarbons) and nitrogen oxides emitted by transport vehicles and by industrial and utility sources. The particulates standard affects a variety of industrial and utility sources. To achieve the NAAQS for these two pollutants requires emissions reductions that vary enormously across the country because of variations in atmospheric conditions, population density, and industrial structure. Some areas, such as the Los Angeles basin, cannot even achieve current standards, much less meet the more ambitious standards now proposed. For this reason, EPA's analysis of the new standards is laced with references to "partial attainment."

The two pollutants involved in this controversy—ozone and particulates—are of considerable interest to students of and propagandists for environmental policy. Photochemical smog, or its primary ingredient, ozone, has always been at the center of the fight against air pollution and the allied battle against the sins of the automobile. The Department of Health, Education, and Welfare first set emission standards for new cars in 1968. In 1970, Congress legislated further reductions in allowable pollution from new cars, which EPA delayed somewhat in response to pleas from the automakers. The standards were once again tightened in the 1977 Clean Air Act Amendments.

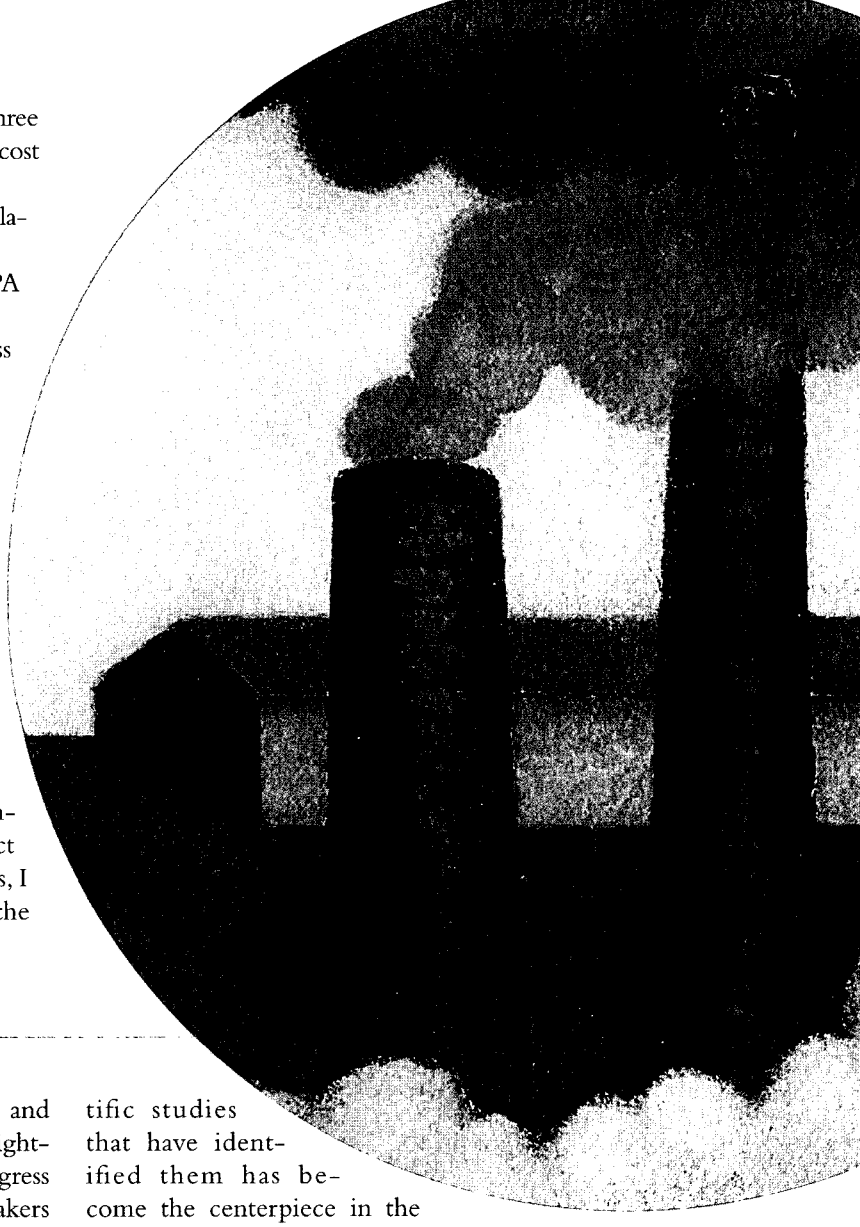
Despite considerable evidence that the health benefits from

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

whether proposed regulations are in the public interest. All three presidents have ordered their regulators to prepare a benefit-cost analysis for major regulations. Each wanted a dispassionate analysis of all positive and negative effects of a proposed regulation, particularly for inherently controversial issues.

As required by President Clinton's executive order, EPA produced a benefit-cost analysis, which led to a different recommendation than the criterion specified by Congress in the Clean Air Act as to what is in the public interest. EPA estimates are annual for 2007 and represent a partial attainment scenario (because the full standards could not be attained with control measures by 2007). For ozone, EPA found that further efforts to attain the current standard had costs that exceed benefits ($1.2 billion, as against $0.1–0.8 billion). Not surprisingly, the proposed more stringent ozone standard also fails a benefit-cost test ($0.1–1.5 billion for benefits, $2.5 billion for costs). In contrast, the new small particles regulation has benefits 10 times greater than the costs ($58–110 billion, as against $6 billion).

EPA is revising the benefits estimate for ozone to account for the effect of ozone abatement on the concentration of particulate matter and to review again the effect of ozone on mortality. While I await the revised estimates, I am skeptical that they will produce benefits that exceed the costs.



controlling photochemical smog are extremely limited and reversible, yet another acrimonious debate led to further tightening of new vehicle emission standards in 1990. Congress once again ratcheted them down, even requiring automakers to produce zero-emission vehicles in markets not meeting the NAAQS for smog or other vehicle-related pollutants. More cost-effective approaches, such as taxing older, dirtier cars, were ignored, as was the evidence that any further reductions in new-vehicle emissions would cost far more than they were worth.

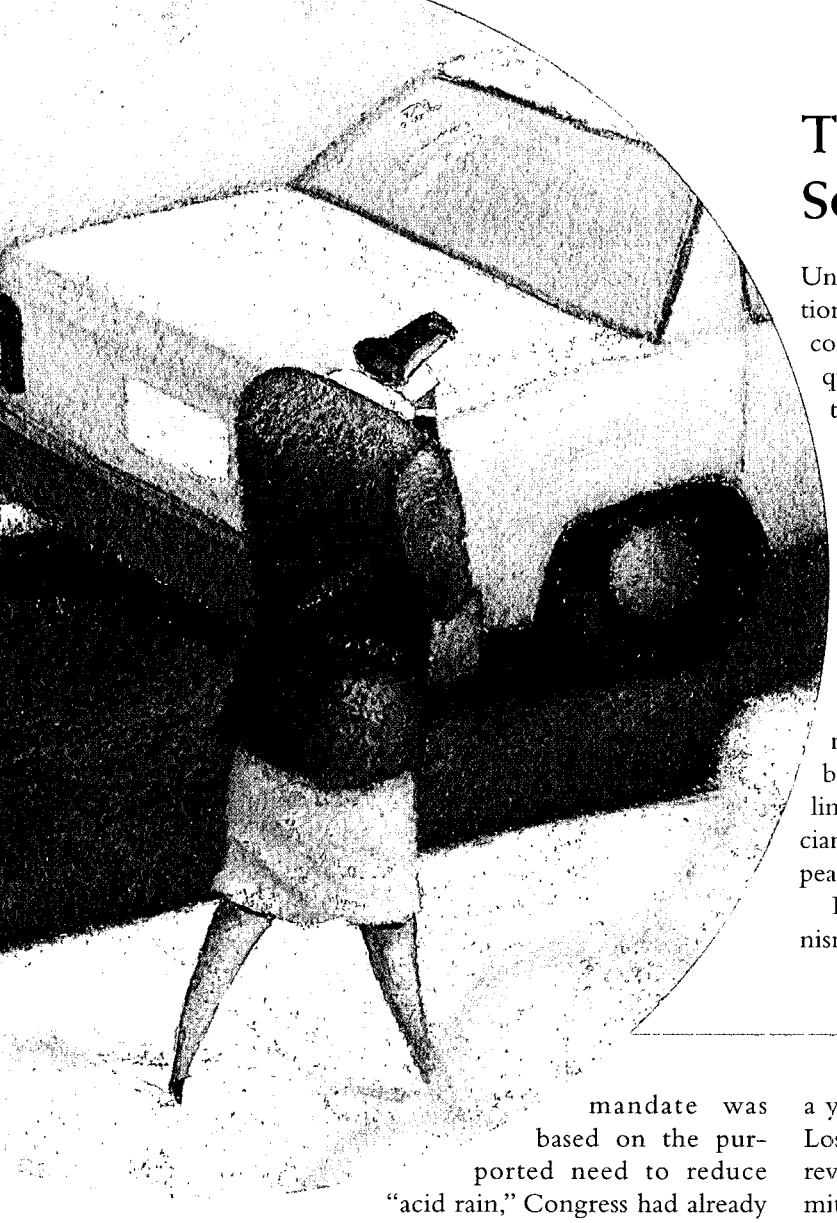
Last year, in response to a congressional mandate, EPA produced a study of the benefits and costs of all air pollution controls imposed between 1970 and 1990. The study, still in draft form, essentially concludes that controls on all automobile-related pollutants have contributed only 0.5 percent of the benefits from the Clean Air Act. The other 99.5 percent are due to particulate matter and lead controls. For all intents and purposes, EPA now concedes that 20 years of beating up on motor vehicles have generated very little value to most Americans.

The particulate standard reflects a new assessment of the dangers posed by inhaling fine, respirable particulate matter. The controversy surrounding the health effects and the scientific studies that have identified them has become the centerpiece in the debate over the EPA proposal. Resolving this controversy is also crucial to justifying the entire clean air program, not just recalibrating this one standard. EPA's own retrospective assessment, citing precisely the same studies, claims that roughly two-thirds of the benefits of the entire program derive from controls implemented for coarse particulates. If these studies are shown to be misleading or invalid, how can EPA justify even the current controls?

EPA now admits that full compliance with either new proposed standard is virtually impossible.

Ironically, the argument for the fine particulate standard may now be used to provide an ex post rationale for the 1990 Clean Air Act's mandate for reducing sulfur-oxide emissions by 10 million tons over two decades. Although the

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED



The Role of Scientific Uncertainty

Uncertainties in both the effects of air pollution and its valuation are a constant issue in clean air regulation. Uncertainty comes into play in translating emissions into ambient air quality; in estimating the adverse effects on health, agriculture, and the environment more generally; in translating the adverse effects of air pollution into dollars; and in estimating the costs of complying with the standards. The uncertainties for the effects of small particles are much greater than those for ozone.

In the past decade, scientists have made considerable progress in understanding both the photochemistry of urban smog and the effects on people and plants. Ozone damages plants and obscures visibility. It is a respiratory irritant that can stop athletes from achieving peak performance or cause pain when people doing strenuous work breathe deeply. It can trigger asthma attacks. While there is a link between high ozone and hospital admissions and physician visits, in general the effects of ozone are reversible, disappearing within a few hours or days.

By contrast, scientists do not yet understand the mechanisms by which small particles in the air affect health.

mandate was based on the purported need to reduce "acid rain," Congress had already received the results of a 10-year, $500 million study that rather decisively laid to rest any argument that such a reduction is justified. The damage caused to forests, lakes, or streams by acid sulfates created from acid rain was far too small to justify the $1 billion to $5 billion per year costs of additional sulfur-oxide abatement. But now the acid-rain justification gives way to health threats posed by fine acid particles and, voila, we have a reason for justifying the 1990 Act's 10-million-ton reduction after all.

Costs and Benefits of the New Standards

Virtually all the benefits from EPA's proposal derive from the fine particulate standard. The tightening of the ozone standard involves a shift in the averaging period that may be justified, but the benefits and costs are relatively small compared with those of the particulate standard.

EPA estimates that even "partial attainment" of the new ozone standard increases costs by $0.6 billion to $2.5 billion a year. (Not even EPA deludes itself about the prospects of Los Angeles achieving the current standard, much less the revised one.) Compliance with a tighter ozone standard will mitigate the threat of reduced pulmonary function, primarily to people exercising or working outside on warm summer days when smog forms. This reduction in lung function is reversible and not serious in most Americans, though for a few with severe respiratory problems it may be more important and may even put them in the hospital. EPA's own estimate of the benefits from just partial attainment is less than its estimate of the costs by as much as $2.4 billion a year. Indeed, even EPA concedes that the potential benefits from this tightening range from $0 to $1.5 billion a year. This is a striking admission—that there is at least some probability that asking us to spend another $0.6 billion to $2.5 billion a year will generate no benefits and a zero probability that the benefits will exceed the cost.

Even more striking, EPA concedes that further compliance with the current standard is not worth the additional costs. Indeed, EPA does not even claim that all the current "nonattainment" areas can meet the current standard. But it estimates the benefits of forcing compliance on some areas not now meeting the standard to be only $0.1 billion to $0.8 billion a year while it estimates the costs of such further "partial attainment" to be $1.2 billion a year. Surely EPA, based on its own analysis, should withdraw its proposal to

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

Dozens of careful studies, however, link small particles to respiratory disease and death in episodes such as the notorious London fog of 1952, on days when particle levels are above average in U.S. cities, and in more polluted cities generally.

A familiar joke about economists is that we are not convinced until we can demonstrate that what is true in the world can be reproduced in theory. Given the many studies linking mortality and morbidity to particulate matter, the joke may be even more appropriate for some health scientists.

Fully understanding the science of health effects is not sufficient for tightening a pollution standard. Abating ozone, for example, is almost certain to reduce asthma attacks, medical visits, and respiratory irritation. But the estimated social benefits of the tightened standard are small and—as noted—fall short of the costs.

The scientific uncertainty that remains about small particles means that the range of benefits from abatement is extremely large. The benefits of meeting the new standard might be $58–110 billion a year, as estimated by EPA, or they might be lower or higher. In my judgment, it is highly unlikely that the benefits of the tightened particle standard would be less than the costs despite the uncertainty involved. Let me illustrate.

The midpoint of the benefit range estimated by EPA is $80 billion; the cost estimate is $6 billion. To take into account the scientific uncertainty, suppose that there is probability P that the benefit would be $80 billion and probability 1 - P that the benefit would be zero. How small would P have to be to justify putting off the more stringent standard?

It is highly unlikely that benefits of the tightened particle standard would be less than the costs despite the uncertainty involved.

If expected benefits equaled costs, 80P = 6 or P = 0.075. In other words, if one thought that the chance of particle abatement having health benefits of $80 billion was less than 7.5 percent, one should put off abatement. On the basis of the more than 100 epidemiological studies done by different investigators on different populations, my judgment is that the chance is much greater than 7.5 percent that particle abatement would have benefits of $80 billion. Thus, it is highly unlikely that the benefits of the tightened particle standard would be less than the costs despite the uncertainty involved.

Fine Particulates and Early Death

Clearly, the proposal to tighten air quality standards hangs on the fine particulate proposal. And that proposal is even more controversial than the ozone standard because of difficulties involved in translating epidemiological data into sound, health-based policy. EPA relies heavily on a battery of recent studies of daily air quality in many large cities. It also cites a few longer-term studies in which various measures of air pollution are correlated with excess mortality rates. These studies document a statistically significant relationship between local pollution and mortality.

Unfortunately, atmospheric conditions cause the levels of most pollutants to rise and fall together, making it difficult to associate the increase in mortality with any single pollutant. But a spate of recent epidemiological studies performed by a small number of researchers generally finds that the level of particulates (coarse or, sometimes, fine) seems to be more closely correlated with these changes in daily mortality than are variations in other pollutants. These results are extremely controversial despite EPA's repeated claims of a scientific "consensus" on the matter. Even EPA's own Clean Air Scientific Advisory Committee, an outside board of advisers, split badly on whether EPA should set a fine particle standard given the available evidence. Two of the twenty-two members found the evidence insufficient to support any fine particle standard. Eight others declined to select a range for the standard, presumably because they felt that the evidence was not sufficiently robust to do so. Seven others supported setting the standard at the upper end of EPA's recommended range—that is, the less stringent end. Only four of the twenty-two were willing to sign on to a standard in the more stringent range of EPA's proposal.

Curiously, no one knows why the correlation between fine particles and early death exists because no one has found laboratory or clinical evidence of such dire effects of particulates at anything like current levels. Indeed, many health scientists have cautioned against moving too rapidly in limiting fine particulates until the science underlying such an attempt to protect human health is better understood.

A Fine Irony

All this is a bit ironic to most students of environmental policy. Usually, regulators are eager to press ahead on the basis of experimental scientific evidence—often from studies on animals or

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

ment is that the chance of abatement having these benefits is perhaps 90 percent. Thus, I see the evidence as strongly favoring abatement.

How do we take into account the possibility that industry would have to invest vast resources to meet the standard, all of which would be wasted if particles didn't have the estimated effect on health? The estimated cost to industry is arrived at by assuming that $30 billion would have to be spent immediately on plant and equipment and an additional $3 billion a year spent on variable costs. (At a 10 percent interest rate, the yearly abatement cost would be $6 billion.) Suppose that the uncertainty over the health effects of particles is to be resolved in five years—we will know whether the benefits are $80 billion a year or zero. Should we tighten the standard today despite the uncertainty?

For simplicity, I don't discount the benefits or costs within the five years. The abatement costs are then $30 + 3(5) = 45$. The benefits are $80(5)P$. Setting benefits equal to costs and solving for P yields $45 = 400P$ or $P = 0.11$. In other words, if we thought there was at least an 11 percent chance that abating particles would lead to this benefit, we should abate today rather than wait for five years.

While I have met scientists who are uncertain, or even skeptical, that the epidemiological studies can be interpreted as causal, I have met no one who thinks there is less than one chance in nine that the association is causal. Thus, I have not met anyone who would decide to put off abatement according to this analysis. Some analysts assert that EPA's estimate of benefits is too high, primarily because it assigns a social loss of $4.8 million to each premature death. That number does appear high for cases where life is shortened by days or weeks. If the average benefit of averting premature death were cut in half, the calculations above would result in doubling P to 15 percent in the first model and 22 percent in the second. I still have not met anyone who has worked with this literature who thinks there is less than one chance in five that small particles have the estimated effect on health.

A more realistic alternative model would admit that abating small particles would have some effect on health, though one smaller than $80 billion. But that effect would have to be 13 times smaller than that estimated by EPA before abatement today would be contrary to the public interest.

I conclude that EPA should promulgate the new particle standard while continuing to support research to isolate the mechanisms by which small particles harm health and isolate which components of small particles require most stringent abatement. Better scientific understanding of small particles might increase the benefits and lower the costs of regulation by targeting more precisely which particles to abate, but failing to implement the new standard is likely to result in tens of thousands of preventable deaths and chronic illnesses.

---

simpler organisms—on cancer risks or some other human health threat, only to be chided for not having any credible statistical evidence that human beings truly are at risk. In today's debate over fine particles, the regulators have a battery of statistical studies that find some association between premature deaths and air pollution that they cannot explain *scientifically*.

Going ahead with the regulations would be very costly—even EPA estimates "partial" compliance with the proposed standard at between $2 billion and $14 billion a year. The benefits could be far less, particularly if the statistical correlation between death rates and particulate levels proves spurious. One might ask, for example, how so many people could be killed on days of high particulate levels unless they were already at death's door from circulatory or respiratory disease. But would not such people be *indoors*? Surely people about to die from congestive heart failure are not typically out in the park for a walk. Perhaps, as suggested elsewhere, the spurious correlation reflects premature mortality caused by elevated levels of *indoor* pollutants that rise and fall with the level of *outdoor* pollutants because of atmospheric conditions, but have a different chemical composition.

Surely people about to die from congestive heart failure are not typically out in the park for a walk.

Whatever the cause of the observed correlation between outdoor air pollution and premature deaths, there is insufficient evidence on the level of fine particles to link them to these day-to-day variations in mortality. EPA and the states have not been collecting data on fine particulates long enough in most areas. For this reason, studies generally use data on total particulates, not just the finer ones, in their statistical regression analysis.

Finally, it must be noted that EPA's analysis of the benefits from setting a tighter and a finer particulate standard assumes that society values a premature death from

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

Clean Air Costs Money

The Clean Air Act reflects the special interests of environmentalists in directing that health be protected without considering abatement costs. When Congress so specified in 1970, it did not anticipate the ingenuity of scientists in tracing health effects at ever lower levels of air pollution. The result is the perennial battle between industry pointing to the costs of compliance and environmentalists saying that a clean environment is a right where abatement costs are irrelevant.

EPA's careful summary of the effects of ozone finds that the benefits are small compared with those for particles and that the costs of the new standard exceed the benefits. As to small particles, even when the uncertainty over the benefits of the new standard is taken into account, benefits exceed abatement costs. Environmental resources would be much better directed against small particles than against ozone.

If careful analysis shows that a regulatory standard's benefits exceed its costs, then society gains from the regulation. Of course it should be implemented at the lowest social cost and disruption—though no one should be surprised that a clean environment costs resources. Unlike Oscar Wilde's cynic who "knows the price of everything and the value of nothing," we need public policies that serve the public interest. ■

exposure to these particles exactly as it values the loss of a healthy, working-age adult who may have 30 to 50 more years to live. But surely someone who dies from temporarily elevated levels of fine particulates must be measuring his or her life expectancy in weeks or months, not years. Thus EPA's calculation that the potential benefits of a tighter particulate standard range from $22 billion to $192 billion a year is wildly exaggerated. A reasonable value for the weeks or months of additional life might reduce this estimate to one-tenth of EPA's estimate or even less.

Defenders of EPA's proposals emphasize that the Clean Air Act requires EPA to protect the health of our citizens from the dangers of air pollution without regard to the costs of such protection. Simply put, benefit-cost analysis is irrelevant. This has been a central flaw in virtually all environmental policy that only Congress can correct. However, when the costs of any regulation per early death averted reach a level of, say, $40 million or $50 million, such a regulation actually *increases* early deaths by withdrawing resources from health care, nutrition, education, and other human consumption. Thus, even under the current Clean Air Act, EPA would be well advised to take costs into account. And when it admits that the benefits from its proposed ozone standard may be as little as $0, it is admitting that such a standard will increase premature mortality by withdrawing $0.6–2.5 billion worth of resources from the economy.

Unattainable Goals

Perhaps the most serious long-term consequence of proceeding down EPA's path toward tighter ozone and particulate standards is that the standards are unattainable. Once again, we will have EPA using the example of Los Angeles to tighten the ozone standard when it knows that LA cannot possibly meet the *current* standard. Thus the truly polluted urban areas will not be affected by the new standards, but the cleaner areas of the country will. Moreover, those areas unable to comply with an unattainable standard will be subjected to federal EPA's arbitrary threats, such as withholding federal highway monies. EPA is not an independent regulatory agency—its management serves at the pleasure of the president. It should not be allowed to set unachievable goals so that it can then process enforcement actions on a capricious and even partisan basis. If EPA proceeds to implement these unattainable standards, Congress can and should overrule this substantial abuse of what is already an abuse of the nondelegation principle valued by the Founding Fathers. Of course, such an override would succeed only if it carried both houses by two-thirds majorities because the president would surely veto this rejection of his appointee's most important policy proposal. ■

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

Continued from page 2

America's Private Schools," winter issue) is so disappointing. Unlike other notable contributions Cookson has made to the academic literature, this essay reads more like a polemic—confusing analytic distinctions, ignoring relevant evidence, and misinterpreting the current direction of the policy debate.

Citing the work of Don Erickson, Cookson begins by explaining the enormous diversity among private schools. They include religious schools associated with Catholic, Jewish, Lutheran, Episcopal, and other Christian congregations; special schools for handicapped children, military academies, alternative schools, urban independent schools and elite boarding schools (of which Cookson has written with expertise). After drawing these important distinctions, he then leaps to a number of generalizations about private institutions: they are less likely to enroll minority students, they can be selective and exclusive, they are "status communities." One must wonder which private schools he is describing here.

Cookson expends much energy refuting the 1982 study by James Coleman, Thomas Hoffer, and Sally Kilgore showing that private and parochial schools outperform public schools academically. He supports his arguments by citing a number of critical studies, but fails to recognize significant research that updated and reanalyzed the data from which Coleman and his colleagues drew their conclusions.

I would first mention the comprehensive (and controversial) study published by John Chubb and Terry Moe in 1990 that sustained the Coleman findings. Then I would note the meticulous 1993 study by Anthony Bryk, Valerie Lee, and Peter Holland demonstrating that Catholic schools are academically superior to public schools and that they are unusually effective in educating inner-city minority children—the very population whose needs have not been adequately addressed by public schools. Contrary to Cookson's claims, these institutions are neither selective nor exclusive; a disproportionate number of them function in urban environments with large populations of poor black and Hispanic students.

The real target of Cookson's essay is the market model and its proposed system of privatization and universal vouchers. He virtually denies that private schools have anything to contribute to the problem of educational failure in the inner city, especially if public dollars are involved. The fact is that few contemporary policy advocates are proponents of full privatization or universal vouchers. The limits of the market are well appreciated. But providing financial assistance that allows poor children to choose private institutions as an alternative to failing public schools is very much a part of the contemporary policy debate.

Programs now under way in Cleveland and Milwaukee are important cases in point. A series of evaluations performed regarding the latter is instructive. John Witte's assessments have shown higher levels of parental satisfaction and similar levels of student performance in the private schools, even though per capita spending was significantly lower. A controlled experiment by Paul Peterson of Harvard indicated significantly higher levels of student performance in private institutions; similar results were revealed by Cecilia Rouse of Princeton. Such evidence should not be ignored.

Joseph P. Viteritti, New York University

BROOKINGS
POLICY BRIEFS

Previous Issues:

We're

The Middle East: Making Oslo Work
no. 19 (June 1997)
Richard N. Haass

A New Strategy for Helping Cities Pay for the Poor
no. 18 (June 1997)
Joseph Gyourko and Anita A. Summers

on the web at

A Better Way to Slow Global Climate Change
no. 17 (June 1997)
Warwick J. McKibbin and Peter J. Wilcoxen

Enlarging NATO: A Questionable Idea Whose Time Has Come
no. 16 (May 1997)
Richard N. Haass

WWW.BROOK.EDU.

The Pentagon's Quadrennial Defense Review
no. 15 (April 1997)
Michael O'Hanlon

Privatizing Social Security: The Troubling Trade-Offs
no. 14 (March 1997)
Gary Burtless and Barry Bosworth

THE BROOKINGS INSTITUTION
1775 MASSACHUSETTS AVE., NW
WASHINGTON, DC 20036-2188

TEL. 202.797.6161
E-MAIL POLICYBRIEF@BROOK.EDU

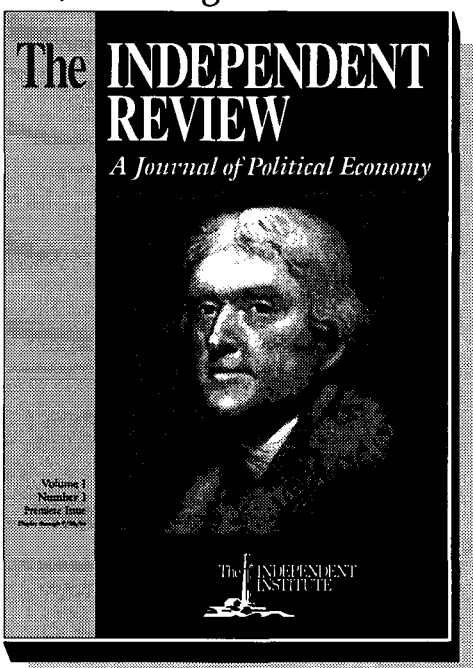
LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

"Superb in addressing complex issues."

— ROBERT W. CRANDALL, Senior Fellow, Brookings Institution

Transcending the all-too-common politicization and superficiality of public policy research and debate, *The INDEPENDENT REVIEW* is the new, interdisciplinary, quarterly journal devoted to excellence in the study of political economy and the critical analysis of government policy. Edited by **Robert Higgs**, *The INDEPENDENT REVIEW* is superbly written, provocative, and based on solid scholarship. Featuring path-breaking studies by many of the world's finest scholars and policy experts, authors represent a variety of disciplines, intellectual traditions, and ideological perspectives.

Probing the most difficult and pressing of social and economic questions, *The INDEPENDENT REVIEW* features in-depth examinations of current issues viewed in comprehensive historical, ethical, and economic perspectives, and written in clear, vigorous English. Undaunted and uncompromising, this is a journal that will pioneer future debate!



"The Independent Review is of great interest."
— C. VANN WOODWARD, Pulitzer Prize-Winner, Yale University

"The Independent Review is an exciting new journal."
— JOHN DIGGINS, Prof. of History, City University of New York

"The Independent Review does not accept the pronouncements of government officials at face value, nor the conventional wisdom over serious public problems."
— JOHN MACARTHUR, Publisher, *Harper's Magazine*

"The Independent Review avoids faddish pyrotechnics while seeking objectivity and high standards."
— TIMUR KURAN, Prof. of Economics, U. of Southern California

"The Independent Review is excellent, diverse and wide-ranging."
— IRVING LOUIS HOROWITZ, Professor of Sociology, Rutgers U.

In Recent Issues:

The Ambitious, Accomodative Adam Smith
— SALIM RASHID

Preventing Banking Crises in the Future
— GEORGE G. KAUFMAN

What is Living and What is Dead in Classical Liberalism?
— CHARLES K. ROWLEY

The End of Welfare and the Contradiction of Compassion
— STEPHEN T. ZILIAK

The International Monetary System in Retrospect
— LELAND B. YEAGER

The Origins of the War on Drugs, 1984-1989
— BRUCE L. BENSON AND DAVID W. RASMUSSEN

Constitutional Rules, Political Accidents and the Course of History
— JENNIFER ROBACK MORSE

Market-Based Environmentalism and the Free Market
— ROY E. CORDATO AND PETER J. HILL

Why the Great Depression Lasted So Long and Why It Ended
— ROBERT HIGGS

The Case Against Psychiatric Coercion
— THOMAS S. SZASZ

- ✦ Feature Articles
- ✦ Book Reviews
- ✦ Special Features
- ✦ Figures and Tables
- ✦ 160 Pages per Issue
- ✦ March, June, Sept. & Dec.
- ✦ Annual Index
- ✦ Plus more . . .

Individual Subscriptions:
$27.95/1 year, $52.95/2 year
Institutional Subscriptions:
$49.95/1 year, $94.95/2 year
International Orders:
Add $28/subscription shipping
California residents add sales tax

Order Toll-Free (U.S.)
800-927-8733
Phone: **510-632-1366**
Fax: **510-568-6040**
review@independent.org
http://www.independent.org

The INDEPENDENT INSTITUTE

Dept. 6P, 134 Ninety-Eighth Ave.
Oakland, CA 94603 U.S.A.

Look for *The INDEPENDENT REVIEW* on better newsstands and in bookstores!

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

NEW FROM

Brookings Institution Press

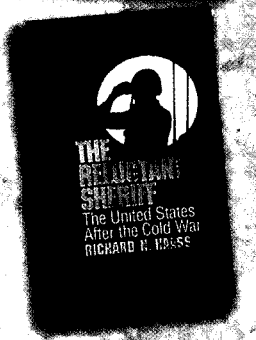
Coming Together?

Mexico-U.S. Relations

Barry P. Bosworth, Susan M. Collins & Nora Claudia Lustig, Editors

Scholars from the U.S. and Mexico examine the major elements of the bilateral relationship. The economic dimension is highlighted in two chapters that focus on NAFTA's effects on trade and financial transactions. The political and social dimensions are taken up in three chapters on immigration, drug trafficking, and environmental concerns.

cloth $38.95 / paper $16.95



The Reluctant Sheriff

The United States after the Cold War

Richard N. Haass

"In this excellent book, Richard Haass illuminates the challenges the post-Cold War world poses for American statesmen. He notes that America's foreign policy must be carefully sized to our resources and convincingly argues that America can afford a foreign policy which protects our interests while respecting our limits." Henry Kissinger.

A Council on Foreign Relations Book

cloth $24.95

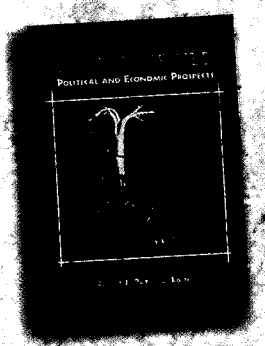
A Half Penny On The Federal Dollar

The Future of Development Aid

Michael O'Hanlon & Carol Graham

"O'Hanlon and Graham have tackled an important but often ignored subject: foreign aid for the poorest countries. Rather than argue for throwing more resources at the problem, they advocate a more selective U.S. approach: targeting development assistance to countries that have adopted sound economic policies. This book—and this approach—bears close scrutiny....The ideas outlined in this book, if adopted, could help restore congressional support for reasonable levels of foreign assistance." Representative Lee H. Hamilton

paper $14.95



Haiti Renewed

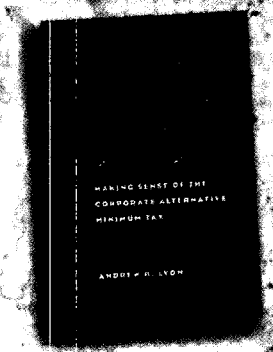
Political and Economic Prospects

Robert I. Rotberg, Editor

This book provides an agenda for Haitian President Préval and his successors, one that examines Haiti's political culture—its historical legacy and what that means for future reconstruction—and many of its most critical political, economic, and social challenges.

Distributed for the World Peace Foundation

cloth $28.95



Cracking The Code

Making Sense of the Corporate Alternative Minimum Tax

Andrew B. Lyon

"Lyon patiently and relentlessly uses both theory and data to analyze the corporate alternative minimum tax. He shows that the logic behind the tax is faulty, and documents its deleterious effects on the economy. Amazingly, he deals with this highly technical material with great lucidity. This book is an invaluable contribution to the policy debate about the appropriate way to tax businesses." Harvey S. Rosen, Princeton University

cloth $38.95 / paper $16.95

Metropolitics

A Regional Agenda for Community and Stability

Myron Orfield

"This is the book we have been waiting for. No study provides greater insights on the causes and consequences of metropolitan polarization. And no study offers a more convincing policy agenda to achieve the political integration of cities and suburbs." William Julius Wilson, Harvard University.

Copublished with the Lincoln Institute of Land Policy

cloth $28.95

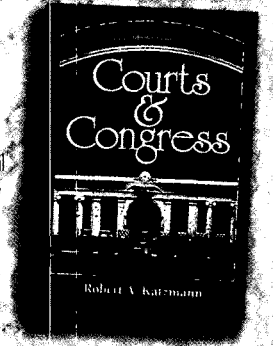
Unconventional Warfare

Rebuilding U.S. Special Operations Forces

Susan L. Marquis

"First, *Unconventional Warfare* is a splendid history of U.S. Special Operations Forces, based on thorough research in primary sources and written with a firm hand. Second, it is a vigorous and thought-provoking analysis of the need for SOF, based on the historical experience and current requirements. Third, it is a pathbreaking work. Military history at its very best. Hearty congratulations to Susan Marquis." Stephen E. Ambrose, Author of *D-Day, June 6, 1944*

cloth $49.95 / paper $19.95



Courts And Congress

Robert A. Katzmann

"There is no such book as this, even as there is no such scholar as Bob Katzmann....The condition of the American courts grows problematic: too large and too broad a case load, too little support. In these matters Presidents are of small consequence; matters will be resolved in the interstices of the relations between the courts and Congress. Now at least we have a guide—and a counselor." Senator Daniel Patrick Moynihan.

Copublished with the Governance Institute

cloth $38.95 / paper $16.95

At bookstores or directly from Brookings: Phone: Toll-free 1-800-275-1447 or (202) 797-6258 • Fax: (202) 797-6004 • E-Mail: BIBOOKS@brook.edu

Visit Brookings online at www.brook.edu

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED